
REINSURANCE IN DEVELOPING COUNTRIES

A Paper presented by

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Mr. Chairman, distinguished ladies and gentlemen.

With the rapid globalisation of trade and industry, the practice of reinsurance in developing countries, as we know it, is undergoing momentous and significant changes. I believe that there is no longer any material difference in reinsurance as practiced in developing countries from that in the more advanced economies.

Having said that I will make another obvious statement, but because it is so important I do not hesitate to make it. The statement is that **without new business we go out of business.**

In this context I refer to both insurance and to reinsurance.

And so in this talk I shall emphasise the action that those who are involved with reinsurance must take to strive to maintain the necessary flow of new business.

The ceding office is concerned about new insurance business, some of which is subsequently reinsured. The reinsurers basically depend upon ceding offices for their business. However, it is the responsibility of reinsurers to show that they can provide all that the ceding offices require of them.

Consequently in this talk I shall concentrate on two features, namely:

1. What ceding offices and reinsurers should do to remain in business; and
2. The alternatives which are available if reinsurance is not used.

1 What ceding offices and reinsurers must do to remain in business.

I suggest that action should be taken in the following areas, both individually and collectively: -

- A. Use of capital wisely to control the downside of the insurance cycle. We need to be prepared to withdraw from the market when realistic returns are no longer probable, and find better uses for surplus resources. Without abandoning flexibility or innovation at all times we must refuse to insure the uninsurable.
- B. A strict code of professionalism and integrity should be adopted so that all dealings and practices are fair, equitable and justifiable in public debate.
- C. We must strive for the highest standards of efficiency and service.
- D. Most importantly, we must not emulate the ostrich which has its head in the sand – we must welcome and exploit technological advances.
- E. There must always be all possible promotion of the partnerships between the different sections of the insurance market. It is vital that there be close cooperation between insurers, reinsurers and the insurance intermediaries, especially insurance and reinsurance brokers.
- F. Competition needs to be healthy and hard.
- G. Overall we must all act as ambassadors for not only our countries but also for our industry and profession. Above all we must never forget that our profession is based upon the important principle of utmost good faith.

As is the position with all activities, insurance and reinsurance are subject to the law. In this respect we must seek to ensure a stable legal framework without retrospective legislation or legal reinterpretations by the Courts. Pressures to limit the freedom to

underwrite must be resisted so that insurable risks can be carried but uninsurable ones are not forced on the market.

Also notation must be taken of such issues as taxation, treatment of reserves, and all forms of regulation. Our governments, I am certain, appreciate the vital role which insurers and reinsurers hold in national economies. On this basis it is with some confidence that I visualise that national governments will enact legislation which will be fair and which will enable us to continue to function satisfactorily. Also that the courts of law will interpret the law equitably in respect of our insuring public, as well as for us, the professionals.

In order to remain in business our particular area of challenge is identified – Customer Focus which we will now consider in more detail.

Customer focus

In respect of customer focus, all players – insurers, reinsurers, loss adjusters and intermediaries – need to identify clearly who is the ultimate customer (as distinct from the intermediary through whom services are delivered). In many cases this could be discussed by asking “who pays the premium?” Having clearly identified the customer, it is then necessary to focus on what that customer really wants, and to distinguish between this and the needs of the intermediary, and the needs of the provider.

With customers’ needs established, consideration must be given to whether these are being met in a professional and efficient way. In practice the “compartmentalised” nature of insurance often cuts across the needs of the client, so that a single perceived need might require contributions from ten or more separate classes of insurance. Such insistence on traditional demarcations in the insurance solution often conflicts with the simple need perceived by the client. We need to be more sensitive to such needs and to accept that, in many instances broader (by which I mean non-insurance) skills might be required to serve client needs.

It is also necessary to identify appropriate sources of additional expertise to seek to enhance our own professional standards. Above all it is necessary to be willing to consider alliances and joint ventures with other professions where these offer the best solutions to client needs. Without such breadth of vision, all players face the continued erosion of their markets by those competitors who are willing to take a more flexible and client-centred view.

The services which are offered could best be marketed by openly addressing the needs of clients, adequately assessing the important requirements, identifying the best solution and making this available. Continuing to insist that the game be played in accordance with the old rules and structure of the market where these no longer align with customer needs is simply playing into the hands of competitors who are more client-centred in their approach.

It is no longer possible to succeed in meeting the needs of major clients by offering a portfolio of products and attempting to impose these as solutions to needs. Instead, we must begin by a careful and systematic analysis of clients' needs, and then tailor solutions to those needs that are both appropriate and cost effective. Increasingly such solutions maybe found to be beyond the conventional insurance portfolio. Thus we must develop the following skills to deliver the appropriate solutions:

Professional standards and competence

Reinsurance can not operate on the basis of "gifted amateurs". We need to attract the best possible quality of new entrants and then provide them with first rate professional training which should cater for some skills which are currently beyond the scope of the insurance market.

Such training can not end with the attainment of a professional qualification; there must also be a genuine commitment to continuous professional development. Standards need to be constantly reviewed and rigorously applied. It is essential that all this needs to be actively supported and encouraged by employers.

Greater efficiency through the use of technology

The drive for transactional effectiveness through the use of computer-based systems must be carried through if our markets are to survive and prosper.

The wider use of technology will also enable us to manage our own risks better, by allowing insurers and reinsurers greater insight into their portfolios of business and their aggregations of exposure.

Competition, but with joint action to promote all aspects of our industry

Healthy competition between all those involved with the reinsurance transactions is essential if high standards of efficiency and competence are to be achieved and maintained. However, there is a need to work collectively to promote the image and virtues of our markets.

Stability of the operating environment

There is a real need for stability, particularly in respect of legal issues and taxation. However, the need is wider than this, and so we must ensure a reliable and secure infrastructure if the required members of our industry are to be recruited and kept therein.

Greater breadth of solutions

Above all, we must guard against complacency and be ever willing to consider new non-traditional approaches that will serve to satisfy the needs of our clients. Only by constant attention to the fundamental needs of our clients and the effective solution of those needs can we hope to prosper into the next millennium.

2 The alternatives which are available if reinsurance is not used

Let us now discuss a number of alternatives. These are:

- A Derivatives
- B Reinsurance for captives
- C Securitisation (of insurance/reinsurance risk)

Derivatives

Derivatives are rapidly becoming an inevitable and key risk management technology in the reinsurance business as well as in the primary insurance business. As more reinsurers consider globalisation it is important that they understand that the business is about “risk allocation and optimisation”. It is here that derivatives could help “propel” the reinsurance market into another stratosphere in terms of attracting capital.

Derivatives bring greater flexibility to the reinsurance market and allow investors to choose and pick which types of risk to invest in, rather than allowing reinsurers to make decisions for them. Derivatives allow one to deconstruct and reconstruct risk that could not be done previously without this technology. And it can be done in a very cheap manner. Derivatives can turn a solid edifice into a Lego set. You can take pieces away and add pieces. Investors in equities might prefer to invest in products which reflect the reinsurance risks they want to take, rather than the ones you want them to take.

As we expand globally we must listen very carefully to the sound of approaching footsteps. They could well be the footsteps of new competitors about to beat you. They will have lots of hustle and lots of knowledge – knowledge of derivatives. It is predicted that insurers and reinsurers would need to make greater use of derivative investment tools to attract new capital and to prosper.

The world market has emerged from the problems of the past and faces considerable new challenges. There are significant opportunities for organisations to achieve superior rates of return. Intellectual and technological capital will be the defining element of the new breed of successful reinsurers.

Although reinsurance fund managers may have traditionally been wary of newer investment techniques, the pain and suffering endured by the world’s reinsurers has some positive impact on the way in which business is transacted.

The markets have changed although the traditional relationship between risk and reward holds true. The focus now in this new world of professional reinsurers will be on the most efficient use of capital, coupled with protecting the capital base from the ravages of the insurance cycle.

Reinsurance for captives

One of the major benefits of using a captive in the corporate insurance programme is the direct access to the professional reinsurance markets. This brings several financial advantages such as:

- More realistic credits for higher deductibles
- Potential for reinsurers to pass on the benefit of their lower expense and acquisition costs, through reduced net premiums or more attractive ceding commission to the captive
- Possible favourable premium payment terms
- Potential for profit commission subject to underwriting results on the programme

Any reduction in corporate insurance costs yields an additional benefit in any territory where premiums are subject to taxes. The benefits are clearly mutual as far as insurers are concerned, as evidenced by the appetite of international reinsurers seeking to increase their participation on captive programmes. Many reinsurers in the past few years have set up specialist divisions, dedicated to serving this market segment – often at the cost of competing internally with their own clients.

In addition to providing insurance for its parent's assets and liabilities on an on-going basis, there is another use of captive reinsurance. That is special one-off situations, such as the transfer of a portfolio of liabilities that may arise as a result of a merger or acquisition, or other change of ownership of the parent, such as privatisation. This may crystallise a book of long-tail liability exposures going back many years which are

unfunded, but for which the captive can provide cover against payment by the parent of an appropriate premium. The captive may in turn seek some reinsurance, such as an aggregate stop-loss or so-called financial reinsurance.

Corporates (through their captives) and reinsurers have been getting to know each other better – but there are still some differences in culture and expectations. Some of the differences between a typical direct or “wholesale” market and a reinsurer’s approach to captive programme are as follows:

- Reinsurers will be looking for strong evidence of above average risk management and loss control programmes, coupled with meaningful retentions
- Reinsurers will track geographical accumulation of property risks very closely
- Reinsurers expect a degree of continuity and for the assureds to stay with them following major loss(es), without (as is often the case), being deserted to cheaper deals in the parent’s domestic market when programmes are immediately remarketed.

Corporate buyers may say that they value continuity of capacity, quality of security, etc, but their actions do not always evidence this. Reinsurers have therefore to acknowledge that some corporates are primarily price buyers, and that they will be put under competition, not just with other reinsurers, but also domestic and international direct insurers.

Alternative solutions to insurance (and particularly reinsurance) are increasingly being sought in the capital markets, such as catastrophes derivatives. Also efforts are underway to provide risk financing for corporates that goes beyond those risks that have traditionally been regarded as uninsurable, for instance to cover a basket of financial risks such as interest rates, exchange rates, commodity prices.

Captives are a natural vehicle to operate these enhanced risk programmes, and reinsurance companies, one of the likely counterparties, may be in alliance with investment banks and other capital providers.

Securitisation

Currently, a search is taking place for a Holy Grail which will allow capital market investors and speculators to participate directly in the risk and rewards of insurance and reinsurance exposures and grant insurers and reinsurers access to the additional capacity of the capital markets.

For an insurance company, pursuit of this aim will only have a purpose if the “reinsurance”, or risk transfer, achieved via such a mechanism is “cheaper” than traditional reinsurance, or is available when there is a shortage of traditional reinsurance capacity. On the other hand, the capital markets investor must be persuaded that the new instrument will provide a better rate of return for the risk he is undertaking than he could achieve elsewhere.

One of the techniques which might allow insurers and investors to achieve these aims is securitisation.

Securitisation is a financing technique which allows the owner of a pool of assets (known as the originator) to repackage those assets into tradable securities issued to third parties. The assets are generally trade or finance receivables due from third party debtors. Repackaging is generally achieved in two steps:

First, the receivables are sold by the originator to a special purpose vehicle (SPV), against a payment of an amount equal to the value of the assets, with no recourse against the originator for non-performance of the underlying debtors.

Second, the SPV funds its purchase of the assets through the issue of asset backed debt securities to investors.

The investors have no recourse other than to the pool of assets which back the securities, and the relevant assets do not appear on the originator's balance sheet. The structure may incorporate some form of credit enhancement to enable the securities issued by the SPV to be given a credit rating.

This technique could, in principle, allow an insurance company to transfer a portfolio of receivables (premiums due under insurance policies) in consideration for an immediate cash payment.

However, a sale of the future premium income itself is of only limited assistance to an insurance company and does not involve the transfer of insurance risk. For most general insurance companies, their insurance contracts are short term; the premium is paid up front and neither party is required to renew the contract the following year. Thus, except in the case of installment premium, there is no future income stream to securitise.

The question then arises as to whether insurance risk can in fact be the subject of securitisation.

A possible structure achieving such a result would be for an insurer to establish an SPV reinsurance company into which it reinsures a particular portfolio of business and pays an agreed premium. The SPV would carry on no other reinsurance business and would issue debt securities into the capital markets. The securities would be issued on terms that the income and/or principal return on the securities would depend upon the loss experience of the portfolio of business reinsured by the SPV.

The insurer would accordingly be transferring all or part of the relevant risks to the holders of the securities, and they would be exposed to the risk of losing income and/or principal if the loss experience under the reinsurance contract is worse than anticipated. On the other hand, if the loss experience is better than anticipated, they would make a positive return. In its most extreme form such a securitisation structure would involve the

capital markets or holders of the debt securities acting as 100% reinsurers of that particular portfolio of business.

Conclusion

Whilst traditional reinsurance is likely to remain the dominant market for the transfer of catastrophe risk at least in the short term, other methods of risk transfer including structured financial products discussed above are likely to become increasingly important. Such structures are more complicated and raise difficult legal and practical problems; but if there is once again pressure on capacity in the traditional markets, there will be an increased impetus to resolve these issues.

Ladies and gentlemen, I hope these brief comments on the changing nature of reinsurance occurring now and continuing into the next millenium, give you some insight as to how traditional methods of reinsurance are being added to; and how our countries' domestic markets can benefit from such developments.

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