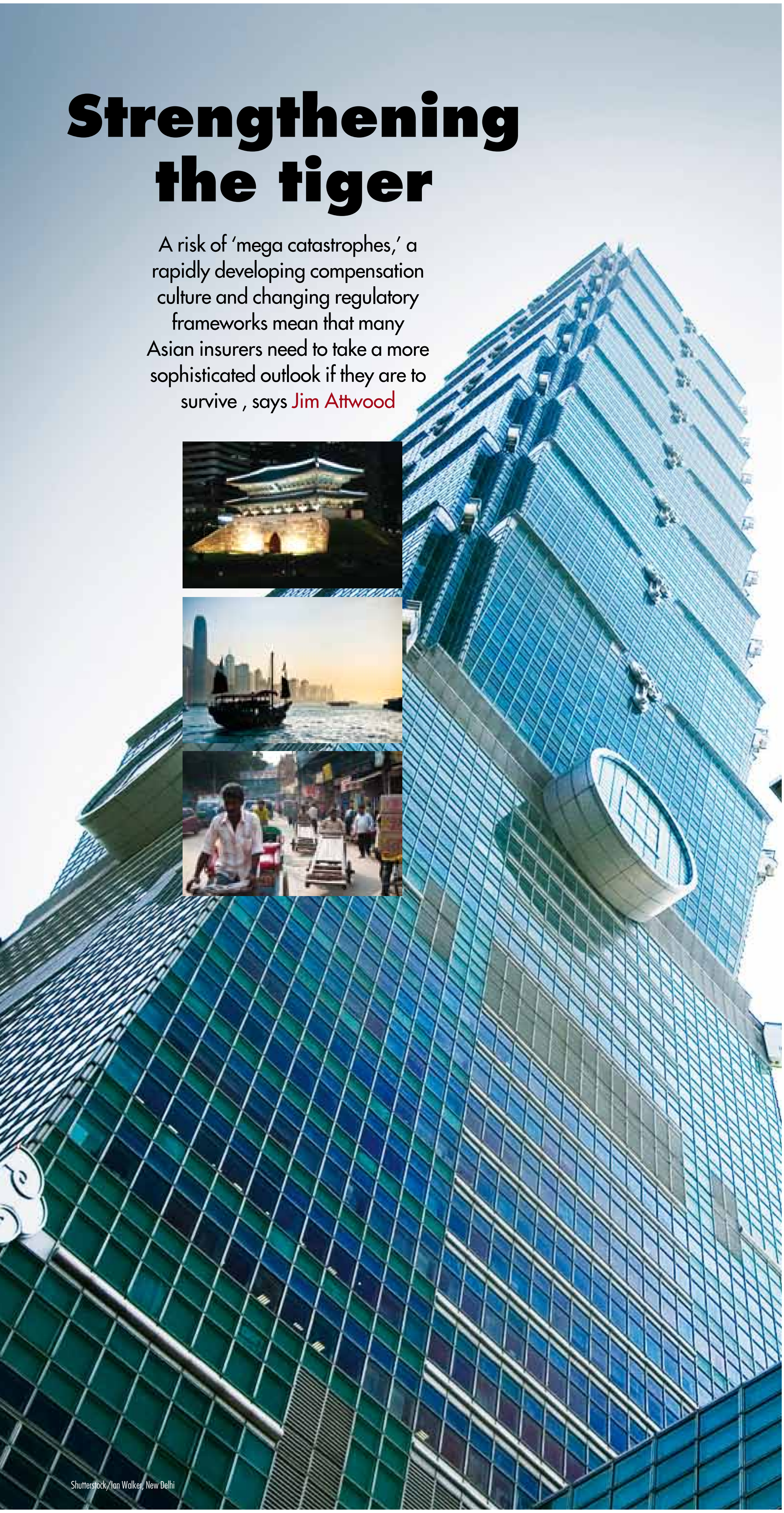
Strengthening the tiger

A risk of 'mega catastrophes,' a rapidly developing compensation culture and changing regulatory frameworks mean that many Asian insurers need to take a more sophisticated outlook if they are to survive , says Jim Attwood



Shutterstock/Ian Walker, New Delhi

The Asian economies have developed into an indispensible engine of global economic growth. Mirroring the region's macro-economic dynamics, Asian insurance markets are expanding at a rapid pace – a bright spot in a generally uninspiring and stagnant global insurance landscape. Direct non-life insurance markets in Asia (including Japan and the Middle East) have grown to US$257 bn in 2009, an inflation-adjusted increase of almst 6% compared with the previous year. The share ceded to reinsurers amounts to close to US$50 bn. These figures correspond to global market shares of about 15% and 30%, respectively.

A continent of contrasts

The region's reinsurance markets display significant differences which reflect primary market characteristics: There are concentrated and relatively mature markets such as South Korea and Taiwan. For example, South Korea's top 10 non-life insurers account for 98% of the market. Accordingly, the aggregate cession rate is comparatively low at less than 11%. In such markets, reinsurance is primarily purchased in order to mitigate (natural) catastrophe exposure and to smooth volatility resulting from such exposures. In stark contrast, the more fragmented markets of South East Asia rely more heavily on reinsurance. In Indonesia, for example, the top 10's market share is relatively low at 55%. Reflecting the small average size of domestic insurers, the aggregate cession rate exceeds 50%. In such markets, primary insurers are relatively poorly capitalized and focus on distribution, rather than risk taking. Some insurance companies are de facto brokers. In such an environment, pro-rata reinsurance is of vital importance as a capital substitute in order to underpin primary insurers' rapid growth.

CHALLENGING HISTORY

However, there are several forces at work which could fundamentally alter reinsurance purchasing behavior in Asia. One trend is Risk-Based Capital (RBC), a solvency regime originally developed in the US which regulators around the world increasingly prefer. RBC is expected to translate into higher average capital requirements which could lead to lower retentions. Asian insurers and their regulators will also closely monitor the transition from Solvency I to the risk-based

THE BRIEF

- RM skills and absorption capabilities of Asian insurers must strengthen
- Global regulation could change use of reinsurance in many Asian markets
- Stakeholders pushing for improved transparency and appropriate RM to nat cat exposures

and economic capital regime of Solvency II in Europe, a move which is expected to transform reinsurance from a rather crude device for obtaining capital relief into a fully fledged risk and capital management tool.

The need for more regulatory capital could also accelerate the trend towards industry consolidation which, in turn, could help transform Asian insurers into genuine risk absorbers. However, the M&A trend has somewhat slowed in the wake of the financial crisis and could also be challenged by more abundant external capital sources available to domestic insurers. Raising capital is widely considered the more attractive option, especially by family-owned insurers which cherish independence. A third option, besides reinsurance and M&A, would be a fundamental review of an insurer's business model, including product design, asset management, pricing and distribution, with the objective of minimizing regulatory capital requirements through 'de-risking'.

Catastrophe consciousness

Another driving force for change is an increasing awareness of the massive natural catastrophe exposures facing the region. Shareholders, regulators, rating agencies and other constituencies push for improved transparency and appropriate risk management responses to these exposures. Natural catastrophe accumulations are rising exponentially and could result in a capacity crunch in the not too distant future – calling for non-traditional, innovative forms of risk transfer. China is a particularly impressive example. The country's rapid industrialization and development, coupled with a huge natural catastrophe exposure will test the limits of insurability. It may lead to exposures to all three major natural perils (earthquake, typhoon and flood) which could easily dwarf 'California Earthquake' or 'European Windstorm' with probable maximum losses of up to US$100bn.

In addition, the risk landscape is undergoing creeping, hardly visible changes with incalculable long-term consequences. The flood exposure of Indonesia's capital Jakarta may serve as an example. Jakarta's current estimated population of 14m continues to grow rapidly. The associated boom in construction activities has led to a water table drawdown, changing the physics of the region and further heightening its vulnerability to severe floods.

But it is not only the physical hazard landscape which is changing: Liability trends from the US (tort system'), the UK (compensation culture) and other parts of the world are making inroads into Asia. For example, product liability in Thailand has recently been tightened to strict liability, meaning that any party involved in handling a product, eg wholesalers, retailers or manufacturers, may be held liable should the product be found faulty. Another example is motor business in China. Bodily injury awards have gone up sharply in recent years, with the payout for a single victim sometimes exceeding RMB 1m, (US$147,152) a compensation level hardly known five years ago.

Against this backdrop, the risk management skills and risk absorption capabilities of Asian insurers will have to strengthen. As a sort of timing bridge reinsurance can facilitate this transition, based on traditional solutions as a first step, but also employing non-traditional risk-sharing and retention finance solutions at a later stage.

Asian insurers are set to place more emphasis on solutions which effectively protect their balance-sheet and bottom-line, in particular against catastrophe risks, and offer more holistic, tailored and cost-effective cover. Having such cover in place will become more important for key stakeholders. This is particularly true for sophisticated investors such as Sovereign Wealth Funds, large industrial conglomerates and Ultra High Net Worth Individuals. They need comfort as to insurers' exposure levels before committing to a continued support of aggressive growth strategies. Having said this, business expansion will remain the name of the game whereas other needs such as the enhancement of capital efficiency are only slowly emerging.

A HOLISTIC APPROACH

In light of a changing operating environment and evolving reinsurance needs, structured reinsurance products meet with increasing demand from Asian cedants. These solutions (both proportional and non-proportional) are of particular interest to clients who want to adopt a more holistic approach to risk management, capture the diversification benefits between different lines of business within their existing portfolio and would like to participate in favourable loss experience. In principle, such covers may also encompass risks on the assets side of the cedant's balance sheet. This feature could be especially appealing to Asian insurers who tend to assume higher investment risks than insurers in other parts of the world.

But structured products are not confined to covering future underwriting years. They may also provide protection against the risk that a cedant's loss reserves are not sufficient to meet all future obligations. This feature is particularly relevant to Asia's fast growth environment where claims reserves tend to exhibit a high volatility. A number of reinsurers offer such Adverse Development Covers, also in combination with conventional prospective quota shares.

A commonly used example of a structured solution is the multi-year / multi-line cover ("MYML") which takes advantage of non-correlating lines to share limits across layers. It can include difficult to place events or risk classes and is set to be cost-effective as it helps clients avoid overpaying for rarely used covers and typically offers some premium refund if loss performance is positive. From the client's perspective there are non-monetary benefits too. The MYML offers planning certainty over multiple years. Prices, terms and conditions are fixed, regardless of market conditions or previous years' loss experience. The client also saves time by avoiding future annual renewals. And, finally, MYMLs offer a rather subtle but attractive benefit: By purchasing long-term quality reinsurance cover the client signals to stakeholders that his company pursues a long-term and strategic approach to risk management.

In Asia, at this point in time, simple multi-year deals, motivated by risk transfer needs and mainly covering property and casualty risks only, are most common.

ILS IN ASIA

The use of insurance-linked securities, especially 'cat bonds', in Asia is still rare and mainly focused on Japan. In 2009, Asia's share of global cumulative ILS issuance (ie capacity) was a mere 12%, with Japan earthquake and Japan typhoon accounting for 7% and 5%, respectively, less than the region's share of global insurance and reinsurance markets. These deals usually come in the form of index-based or parametric trigger solutions which entail basis risk: The sponsor is faced with a difference between actual losses and the losses implied by the index or parametric trigger (eg the overall industry loss). Basis risk is a major obstacle to the spread of cat bonds in Asia as domestic insurers display a deep-seated lack of confidence in catastrophe models. However, modeling firms are raising their game in Asia and confidence in their projections should grow over time.

In summary, Asia's reinsurance markets are gradually morphing – from a rather unsophisticated environment with just traditional reinsurance needs catering to low capital levels and distribution-focused business models to a more demanding market place where players seek more holistic, bespoke and cost-effective solutions.®