Raising retention in the Middle East

The solution to raising retention levels in the region may lie with large dominant reinsurers which have the muscle to push for change, says **Mr Rainer Lehner** of **Asia Capital Re**.

Risk retention has long been a hot topic for (re) insurers. Yet, little has changed over the years. While some may assume low levels of capitalisation to be the reason behind this, it is not quite the case in the Middle East.

Certainly, overall retention levels might have increased in recent years in the region, but these were driven not only largely by the higher retention on personal lines but also poor performance of proportional treaties, which forced insurers to retain more instead of reinsuring on a proportional basis. At the same time, those cedants who raised their retention levels on proportional treaties did so almost always with the protection of excess of loss covers, which often resulted ultimately in very low absolute net retention of less than 1% of capital. In the lines of property, engineering and energy, there have been even less development in retention levels to speak of.

Unlike in other markets which may blame low levels of capitalisation for low retention levels, the phenomenon in the Middle East where insurers are generally well-capitalised can be attributed more to an abundance of reinsurance capital, limited risk appetites and technical skills, and perhaps, even just a matter of habit.

Of all stakeholders, reinsurers can probably play the biggest part in finding a solution to raising risk retention. By exercising pressure for increased retention at renewals and meaningful participation on risks, reinsurers can influence the market place without requiring regulatory intervention.

Dependence on reinsurance

Most insurance companies here have gotten used to ceding out most of their risks. This is in no small part because commissions provide reliable income with low risk, which limits their appetite for higher retention and risk. Furthermore, with rates at a very competitive level, it is certainly far more lucrative for insurers to maintain their balance sheets with only minimal exposure while enjoying a stable income source in commissions.

Therein lies a significant potential moral hazard. In transferring their underwriting risks almost entirely to reinsurers, insurers bear "little skin in the game" which heavily dilutes an important component of their underwriting raison d'être, i.e. the risk taking aspect. In recent days, we have seen, for example, risks getting placed with minimal information. This eroding underwriting discipline will lead to excessive risk accumulation. Compounding the issue is the high turnover of underwriters in the Middle East market, where almost 100% of its underwriters are expatriates and thus very transient. This has direct implications on the accountability of underwriters and their underwriting process.

The challenge is probably more pronounced in the facultative than the treaty market as the former, being more of a short-term opportunistic market, is the better choice to offload undesirable risks. On the other hand, insurers tend to protect their treaties as they would otherwise have to face the music with their reinsurers at the following renewal.

If the market were left to regulate itself, it will take quite some time as the abundant reinsurance and retrocession capacity available in the Middle East market isn't going away any time soon. As such, we may be looking at some instability in the market in the near future brought on by excessive risk accumulation due to the domino effects of deteriorating underwriting discipline. It may also lead to price volatility if a large event were to take place and reinsurers were no longer willing to bear the losses.

The way to equitable risk retention

Higher or more equitable risk retention levels can help to increase the efficiency and stability of the market place and add to its transparency. Regulations can step in to introduce minimum retention guidelines. For example, insurers can be given a bigger stake in the market by applying more refined risk-based capital requirements that stipulate higher costs for counterparty credit risks. On the part of insurers, they should perhaps critically examine their role in the financial eco-system and consider what types of risks should be ceded (and what should not). Insurance carriers should certainly continue to reinsure larger risks but would do well to retain the smaller ones.

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However, this can only be achieved if insurers were unable to find alternative reinsurers who do not impose such restrictions. At this point in time though, reinsurer capacity is still in ample supply. For now, the question of when this will and can happen therefore may be answered by the large and dominant reinsurers in the region which have the muscle to push for a change in the market. Otherwise, the wait for a meaningful increase in retention levels will likely take a few more years.

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