

Challenges facing our industry

What is a mega risk? What are the challenges facing our industry? What makes Asia different from the rest of the world? Why should we be concerned? **Mr Jim Attwood**, Chief Underwriting Officer, Facultative & Specialty, Asia Capital Reinsurance Group, examines some technical and structural inefficiencies within the insurance landscape for mega risks which can lead to mis-pricing, anti-selection, and unsustainable cross-subsidies.



First, some technical stuff. A mega risk is an individual object with a high sum insured. Though there is no standard definition to it, let us say for example that the definition is taken as an insured risk with a US\$500 million or greater maximum foreseeable loss (MFL) including business interruption.

Only a few sentences into this article and I have hit a key technical challenge for our industry – How to define loss potential for what is usually a complex, non-standard risk?

Mega economies produce mega risks

MFL is typically defined so that there is no allowance for any risk mitigation measures of the insured, which is typical in Asia although conservative (too high) in many cases.

It is generally hard to obtain complete and high quality data on mega risks (as defined), but to the extent the facultative market is any indicator, there is a significant concentration of mega risks within Australasia, Japan and the “Asian Tigers”: Singapore, Hong Kong, Taiwan and South Korea. China will of course have the largest concentration in years to come, but it is not there yet. It should be no surprises that mega economies produce mega risks.

Each insurance firm will have its own way to determine the loss potential of an individual risk, and terms like MFL and probable maximum loss (PML) are common whilst poorly defined.

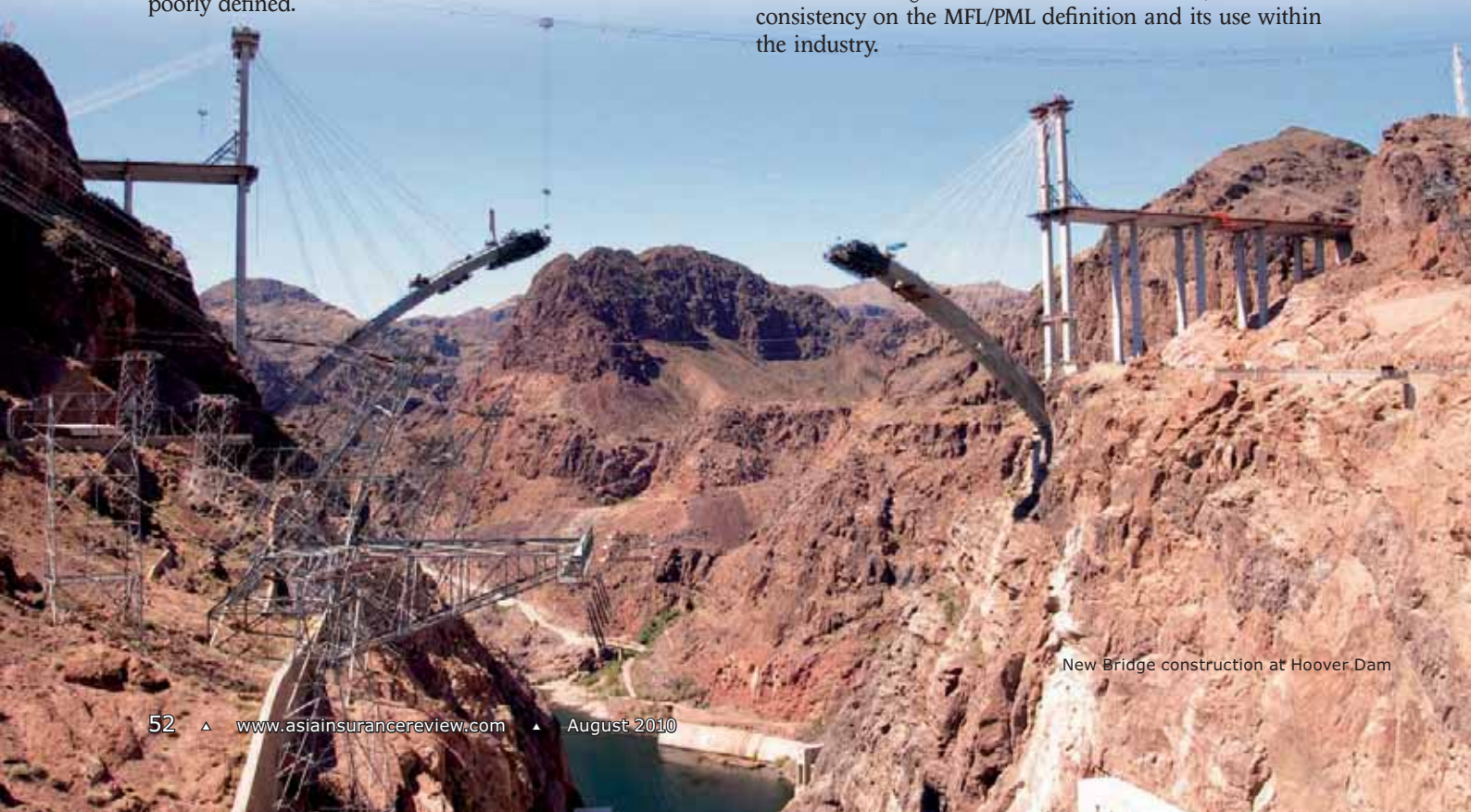
Wide variances in definition of mega risks

The issue goes beyond the word games:

- Typically mega risks require significant insurance and reinsurance capacity, and dozens of insurers can be involved in the overall placement of the risk. Insurers use MFLs/PMLs and the likes for allocating capacity, and as an important element in pricing. Differences in MFL/PML will lead to wide differences in pricing especially in the professional reinsurance market that uses the MFL/PML explicitly;
- Asia is a heterogeneous area that has a wide diversity of cultures, countries, and regions and each with its own idiosyncrasies. Risk management standards are varied. Effectiveness of risk mitigation is hard to assess without the proper resources and expertise, and right now, expertise is just not there in terms of number of people on the ground in each country.

Risks may be overpriced

I should clarify my assertion that the terms MFL/PML are poorly defined. I believe that the professional reinsurance market will have very precise definitions within their own organisations – the issue is that this might be defined in a global context without recognition of the peculiarities of local risk management standards. In addition, there is no consistency on the MFL/PML definition and its use within the industry.



New Bridge construction at Hoover Dam



Boeing Everett Plant

The overall effect of this inconsistency of definition is, in my view, that risks are overpriced! Few underwriters in Asia would be taking into account all the risk mitigation measures put in place since there is a general level of scepticism about “Asian standards”. Thus loss potential estimates would generally be conservative.

I am sure many readers would be horrified by my suggestion of over-pricing as the general perception would be that risks in Asia are underpriced.

There is not enough evidence one way or the other to prove or disprove my statement, but the anecdotal frequency of large losses is very low across many of the emerging markets of Asia. Perhaps we have been lucky... or perhaps we are systematically overestimating the loss potential for mega risks in the region and consequently overpricing them? Time will tell.

Estimation of loss potential “too conservative”

I would be interested in any readers who are aware of a loss in excess of an MFL/PML estimate in Asia in the last 20 years or so. “PML bust” losses as they are often termed are relatively common in Europe and North America.

The consequences of a “too conservative” estimation of the loss potential and therefore mis-pricing is that you cannot tell the difference between those risks which are genuinely well priced risks and those which are not.

Risk selection becomes even more difficult than it would otherwise be, and perhaps no better than a lottery, since in a lottery at least every participant has an even chance. Here, your better resourced competitors can select the better risks, leaving you over weighted on the poorly priced risks – a classical example of anti-selection.

Structural inefficiency

Setting the loss potential is only one of the many technical challenges facing the industry.

There is also an important structural issue. There are a large number of small local insurers in the region competing to insure the mega risk sector. These small local insurers generally lack capital and expertise, but it is not in their business models to retain mega risk exposure. Their business model is to take a commission on the premium that flows through their respective organisations.

Huge treaty and facultative capacity required for mega risks mean that most local insurance companies can participate in the insurance of the local mega risks, irrespective of the quality of the risk.

This is a very cynical view of the market place, and like most things in Asia, the issue is never that clear cut, but

the competition for these commission dollars is fierce. Can it last? Of course not.

These commission costs are a significant frictional cost in the process, and ultimately market forces will disintermediate insurers unless they can add value in the chain of production to the long term benefit of the ultimate customer – the insured.

Proportional treaties bearing mega risks’ costs

Having said that, in the current environment, perhaps the insured is not actually bearing these frictional costs.

I strongly suspect that these costs are being borne by the providers of proportional treaty capacity. The margins within such treaties are traditionally small but stable, and justified on the basis that the underlying portfolios are large, well diversified and well balanced. I don’t believe the balance is really there! It cannot be – many small risks are subsidising those few mega risks.

The inclusion of mega and complex risks will eventually undermine the sustainability of these treaties; and if the insurers want to continue to enjoy its current levels of commission, mega risks will gradually come out of the treaties and be insured by specialist insurers and reinsurers.

However, I do think any change will be gradual. The inherent cross-subsidy within the design of proportional treaty is yet to be really tested. The snow storm in China in 2008 was a small test, and the reaction of the market was to exclude transmission lines from the treaties; eventually we can expect the same for mega and complex risks, but the market will unfortunately wait until it loses money before getting its house in order.

What’s next?

What can an insured do to take advantage of the technical and structural inefficiencies in the market?

Well, for the average or poorly managed risk, there is no incentive to do anything in the short term. They are benefiting from the inefficiencies – indeed, there is not much short term incentive for improving risk management and risk quality, since it will cost money and the insurance industry will not necessarily change its view of the company via reduced premiums.

However, for well risk managed companies, there is a big incentive to increase efficiency and to cease the inherent cross subsidy for their competitors’ insurance costs.

One way for the “best in class” companies to benefit from their risk management superiority is to retain more risk. However, this is a fairly daunting prospect for many, especially because the culture of a well risk managed company is to be conservative and a bigger retention flies in the face of this conservatism.

Some have turned to captive insurance or multi-year structured primaries (MYSP) covers whereby significant return premiums are available to reward long term low claims experience, but the number of insureds going this route is relatively small.

Further, insureds can do little about the structure of commission on proportional treaties, other than enjoy the benefits. They should however keep one eye on the future and prepare for the day when these cross subsidies no longer exist. That day will come. ■