

Broadening your horizons

Sal Zaffino considers the importance of diversifying reinsurance placements.



Sal Zaffino is chief executive of global reinsurance intermediary Guy Carpenter.

In finance, diversification is a widely accepted principle. If all of an investor's funds are invested in one asset class, the investor runs the risk of total ruin if that asset fails.

The recent example of the burst of the technology stock bubble, where some individuals held practically all of their nest eggs in a few "hot" tech stocks, bears testimony to the pain suffered by market players who did not follow the diversification principle.

When applied to reinsurance, this principle suggests that cedants should spread their reinsurance programs among a variety of reinsurers to avoid the risk of default on their reinsurance contracts — and of grievous financial loss — in the event of reinsurance company failures.

Diversification reduces cedants' exposure to reinsurance company default risk. This is probably the single most important reason for insurers to diversify their reinsurance placements. However, insurers use diversification for a number of other reasons.

For example, many reinsurance placements are so large that they require the participation of a sizeable number of reinsurers.

Spread of business

In addition, during soft markets, cedants may decide to spread their business among a wide variety of reinsurers with the idea that by giving reinsurers business under soft market conditions, the reinsurers will be loyal to them in hard market periods.

Diversification also plays an important role in increasing competition in the reinsurance market. By accepting bids from new market entrants, insurers may potentially exert competitive pressure on other reinsurers in their programmes.

The benefits of diversification are based on one key assumption: that risks are not correlated. In the case of the investor in tech stocks cited previously, there was little benefit to diversification among individual tech stocks, since the whole sector collapsed.

Unique correlations

Certain risk correlations are unique to the world of reinsurance, and cedants must keep them in mind when placing reinsurance. Such risks in the reinsurance market include:

- The correlation of default risk across reinsurers. Certain events could cause a number of reinsurers to collapse at the same time, particularly if they are

writing the same type of coverage or are reinsuring business in the same local market.

Consider, for example, the case of reinsurers providing, primarily, property and catastrophe cover. In the event of a major catastrophe, there might be such a significant accumulation of losses in these reinsurers' portfolios that they could all face the risk of insolvency.

- The correlation between the risk of loss to a cedant and the default risk of reinsurers. Cedants suffering substantial losses from a certain category of claims may find that their reinsurers are affected even more severely in the same category. For example, a cedant that wishes to transfer losses for product liability in a certain industry may wish to avoid reinsurers that already have high exposure in that field.

Default risk

Cedants may also diversify their risk transfer partners outside the traditional reinsurance market. Catastrophe bonds and other forms of non-traditional risk transfer may be available to significantly minimise default risk and thus help ensure that coverage is available in the event of a mega-catastrophe.

In these examples, the risk cited for cedants is that of default by reinsurers. However, cedants are not just concerned with default risk. They also have concerns with delays, and partial recoveries that can occur when a reinsurer gets into financial trouble but does not become insolvent. The considerations on diversification that we have reviewed here apply equally well to those situations.

Benefits of variety

Professional reinsurance brokers have great experience in working with a wide variety of reinsurers that have unrelated exposures and operate in different geographical areas. This experience, and the knowledge and resources of their market security teams, can be brought to bear in designing a risk transfer programme that works best for each client.

In addition, most large brokers can also help their clients explore non-traditional coverage, enabling them to diversify away from their dependence on traditional products.

By turning to brokers for help in placing reinsurance coverage, insurers can get great assistance in identifying, analysing, and responding to the risk of delayed or zero recovery on their reinsurance contracts.

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