

The bigger picture



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The move to a dynamic and holistic approach to market security is vital says **Peter Zaffino.**



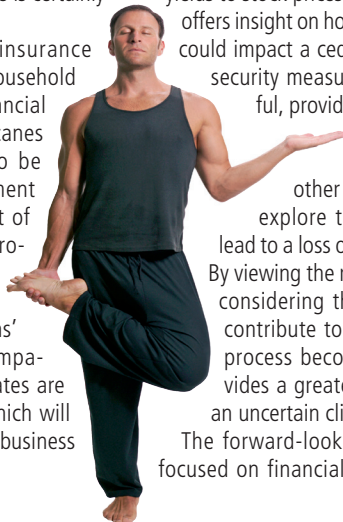
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It's hardly surprising that market security has become a greater priority for cedents around the world. Both natural perils and financial catastrophes have resulted in a substantial reduction in the aggregate amount of capital available in the insurance industry.

While the stability of our business environment was generally good, most carriers realised that they needed to prepare for the unimaginable. Counterparty credit risk is now approached with a heightened level of concern and diligence. At the 1 January renewal, reinsurers began to take a holistic view, a trend that is unlikely to abate in the near future.

In the past, market security was focused on insurance entities. Analysts generally devoted most of their time to the finances of property-casualty insurers and life insurers. In some cases, the same level of scrutiny may not have been applied to the insurance affiliates' larger holdings companies. This is certainly going to change in the future.

Last year, many of the insurance and reinsurance industry's household names sustained severe financial losses. Estimates from Hurricanes Gustav and Ike continue to be revised upward, and investment asset impairment (as a result of the ongoing financial catastrophe) is still being disclosed. These developments are not limited to insurance operations' balance sheets. Holding companies and non-insurance affiliates are revealing losses of capital, which will undoubtedly affect insurance business units.



The shifting landscape has led to the use of financial performance measures not traditionally included in the insurance analyst's review. New focus has been placed on stock performance, bond and credit default swap (CDS) pricing, and peer review – extending even beyond the insurance industry. The increase in cedent diligence has reshaped the process of evaluating market security, which will cause reinsurers to face a variety of new information requests.

Yet, probing inquiries and longer discussions comprise only part of this transformation. Market security is beginning to look toward the future.

The use of financial indicators – from bond yields to stock prices – to evaluate reinsurers offers insight on how market developments could impact a cedent. Traditional market security measures, which remain useful, provide a snapshot at the time of renewal. Financial indicators, on the other hand, allow insurers to explore the scenarios that may lead to a loss of surplus in future years. By viewing the reinsurer as a whole and considering the various factors that contribute to financial strength, the process becomes dynamic and provides a greater level of protection in an uncertain climate.

The forward-looking indicators, though focused on financial markets, also provide

some insight into the implications of the physical events that carriers cover. In the event of a severe hurricane, for example, an insurer's or reinsurer's stock price may decline and provide a perspective on the financial damages that follow. Such an indication would

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complement news releases from the insurer on the size of the loss. While management may appear to be overly optimistic on the

impact of the company's balance sheet, the market will not be confused.

Knowing more about the financial picture of counterparties will assist cedents and their brokers in actively managing the reinsurance recoverable asset (RRA), including an accelerated liquidation when indicated by reliable market factors. Advantages derived from this approach include improved liquidity, relief from capital loadings and the transformation of the RRA to a remunerative asset.

This new view of market security is unlikely to change.

Now that the entire insurance industry has seen how a financial event occurring at the holding and non-insurance affiliate level can cut deeply into insurer and reinsurer balance sheets, the need for this new, broader approach to market security is clear. A dynamic, holistic view of the reinsurer can provide guidance to cedents in choosing their potential counterparties. Supplemented by a diversified panel of reinsurers, this broader analysis can reduce counterparty risk. 