

Crucial tactics

The hit sustained by the industry over the past catastrophe season, combined with wider global economic pressures, means that reinsurers must pay more attention than ever to their capital management strategies, argues **Nick Frankland**.



As with everything that happened last year, the reinsurance industry's 2008 full-year financial results are open to interpretation. One could focus on the Guy Carpenter Global Reinsurance Composite's shareholders funds decline of \$19.7bn – not to mention a total net loss of \$6.1bn – or zero in on the fact that most of this came from unrealised investment losses and note that most companies showed underwriting profits. Either way, capital has been depleted and the capital positions that carried us through 2008 are not around this year. More than ever, capital management should be a top priority for every bearer of risk.

Even before the results were revealed, most expected them to be unpleasant. Shareholders' funds fell 18% year on year, only slightly more than the 15% to 17% range we anticipated. Given the effects of both the hurricane season and the ongoing financial catastrophe, this is not an unreasonable result and the ability of the industry to operate effectively (unlike the banking sector) was not called into question. It looked like our industry would persevere and now we have confirmed it.

The Global Reinsurance Composite posted an aggregate underwriting profit of \$1.2bn in 2008 – that is down 78% from the year before. While that is a substantial drop, the

fact that 2007 was one of the most expensive catastrophe years since at least 1970 is sufficient explanation and it was exacerbated by turmoil in financial markets around the world. The insurance industry did not emerge completely unscathed, though risk bearers were able to demonstrate strength in their core competency: understanding and managing risk.

Despite this optimistic perspective, the numbers themselves are still painful – at least until you look beneath the surface. Therefore, how we approach risk and capital deployment will have to change.

Vigilance needed

The brute force of robust balance sheets is no longer at our disposal; simply absorbing losses will not work as well as it did last year. Rather, portfolios should be scoured for stubborn perils, hidden accumulations and other potential pitfalls that could deplete capital further in the event of an insured loss – especially a property mega-catastrophe or a large casualty catastrophe. Renewed vigilance has become necessary as the margin of error once allowed by overflowing coffers has eroded.

Holistic risk and capital management that touches every corner of the company may be the only way to protect balance sheets from the dual pressures of potential financial market and natural catastrophe losses this year.

Yes, this raises the issue of enterprise risk management, a concept that some feel let the industry down in 2008. Companies with ERM frameworks in place lost considerable amounts of capital, despite the protective measures in which they had invested.

Instead of rushing to blame ERM or the use of models that it entails, the apparent failure of risk controls last year was really a shortfall in strategic planning. The ERM frameworks in place did not necessarily address the full spectrum of risks – from covered physical events to financial markets – that many companies faced. In some cases, insufficient diligence resulted in risk management gaps that were not identified and these exposures ultimately gave entry to the effects of the worldwide financial catastrophe. An ERM framework is only as effective as the planning process that underlies it.

Last year offered a lesson in ERM that should be applied throughout 2009. Disciplined underwriting practices address only one facet of risk and even the application of theoretically flawless assumptions to a carefully constructed portfolio of insurance risks using model outputs reflective of genuine fortune-telling (namely absolutely perfect insurance portfolio risk management) constitutes only partial risk management. The asset side of the balance sheet, which fuels underwriting activity, must be wrapped into a broader effort to manage capital and measure the results of its use.

Two renewals are behind us but the year is still young. We still have two more – Florida at the beginning of June followed by the 1 July renewal – and all of the hurricane season ahead of us. Capital management decisions made now therefore will have near-term implications, in addition to contributing to a platform for strong profitability that could last well into the future. Consequently, the best ERM investments will address the notion of 'entire company' to its fullest extent, leaving no risk unexamined and adding keen risk manager insight to the intelligence gleaned from models and loss histories. Planning and execution, consequently, will become the most powerful differentiators in the reinsurance industry this year.



Nick Frankland is chief executive officer, European operations, Guy Carpenter

