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Enterprise Risk Management and Reinsurance for Property and Casualty Insurers

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Insurers are in the business of aggregating risk. This makes enterprise risk management (ERM) particularly important to insurers.

In addition, property and casualty (P&C) insurers have an incredibly flexible and powerful tool available for sculpting their risks: reinsurance.

ERM is a very new approach to risk that has been embraced by insurers just in the past 15 years. Reinsurance, on the other hand, has been around for almost as long as insurance. Do they work together? Can the new ERM process learn from the mature reinsurance approach?

The answers are yes and yes.

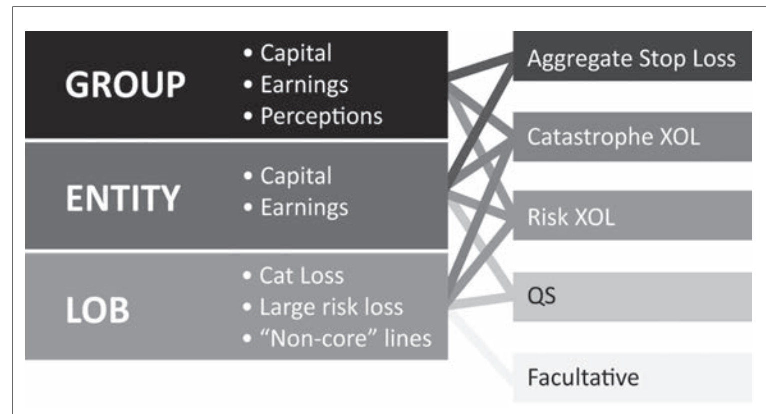
INSURER'S PERSPECTIVE

ERM can be thought of as having three stages that build on each other. The first stage is "individual risk management." In this stage, insurers will concentrate on making sure that they are addressing each of their key risks appropriately. In this stage, insurers will concentrate on making sure that they are consistently addressing all of their key risks—and addressing those risks in a transparent and disciplined manner.

The risk profile of a P&C insurer is much different from that of a life insurer. Often the majority of risk exposure comes from the insurance risks, while the majority of the risk profile of life insurers often comes from investment risks. So in the individual risk management stage, P&C insurers can use reinsurance to carefully mold their retention.

An insurer's ERM process looks very much like the process of designing a reinsurance program. Both start with the articulation of risk appetite and tolerance—how much and what kind of risk the insurer wants to have (retain) at the end of the process (though the reinsurance world may not have used those particular terms until recently). Figure 1 shows how insurers look at risk from a variety of perspectives and choose from a variety of reinsurance tools[1] to achieve their desired outcomes.

Figure 1
Risk Determines Reinsurance Tool



Source: Alice Underwod, FCAS

The second stage of ERM is called aggregate risk management. In this stage, ERM is focused upon achieving a predetermined relationship between risk and risk-bearing capital. This stage is usually associated with the concept of risk appetite and tolerance.

Because reinsurance purchasing is a familiar process, insurers seeking to establish an ERM framework can draw upon this experience to inform their ERM risk appetite and tolerance. Management choices about reinsurance protection illustrate how much insurance risk a company is willing to retain from individual insureds, single events, lines of business and annual underwriting results. ERM-related risk tolerances can be developed by extending the reinsurance thinking to other risks.

If, for a variety of reasons, an insurer finds that its aggregate risk does exceed its risk tolerance, the insurer has a number of options, several of which are tied to reinsurance:

1. Change investment strategy.
2. Raise capital.
3. Change underwriting policies.
4. Modify reinsurance program:
    - Buy additional reinsurance cover through reinsuring an additional part of the business.
    - Reduce attachment and/or increase limit.
    - Increase percentage placed.

In many cases, insurers will find that the reinsurance options are the least disruptive of company operations and often the most economical as well.

The third stage of ERM is risk reward management. Under this stage, a corporate group will look at the risk-adjusted returns of all of the insurer's major activities and help steer decision-making toward achieving a good risk adjusted for the entire group.

In this stage, ERM thinking may also influence reinsurance decisions. For insurers with significant reinsurance purchases and developing ERM programs, the ERM thinking often spurs an evolution of reinsurance philosophy. Taking an enterprise-wide view of the risk profile, companies often choose to consolidate historically separate purchases on similar risks, thereby taking advantage of diversification benefits and efficiencies of scale. As they develop greater confidence in their selected risk appetites, insurers may decide to calibrate reinsurance structures to achieve better alignment with corporate strategy. And they may adjust the balance of retained risk among lines of business in light of temporary or longer-term differences in risk-adjusted returns.

PERSPECTIVE OF RATING AGENCIES AND REGULATORS

At the same time, outside bodies such as rating agencies and regulators have been urging that insurers take up ERM. They all agree that reinsurance is a crucial risk management tool and will want to learn how well the reinsurance program fits with ERM goals.

Starting in 2005 at Standard & Poor's and in 2008 at AM Best, the rating agencies have considered risk management an important aspect of their ratings of insurers. They look for insurers to apply a not-too-hot, not-too-cold approach to reinsurance. Insurers are expected to transfer out a significant part of the high-end, "catastrophic" risks in their insurance portfolios to reinsurers. An insurer that retains too much of its extreme tail risk is seen to have a poor risk management approach. But insurers can also be judged for buying too much reinsurance. Those insurers are seen by the rating agencies as being overly dependent upon reinsurance and unable to continue their business strategy without that support. When a catastrophic event does occur, such as a hurricane, the rating agencies will look to see that insurers have in fact purchased the right amount and form of reinsurance by reporting losses that parallel the bulk of the industry.

In the U.S. and Canada, insurance regulators have adopted requirements for an "Own Risk and Solvency Assessment" (ORSA). As a part of the ORSA process, insurers will do advance stress testing of the exact sorts of events that are discussed above. The regulators will not have to wait until after a catastrophic event to see if insurers have purchased sufficient reinsurance.

The ORSA process involves creating a series of stress tests that are related to all the key risks of the insurer and then determining the impact on the insurer's earnings, surplus and risk tolerance of the stress scenario. Unique to the ORSA process, insurers are encouraged to look at the scenarios where the loss causes them to breach their risk tolerance and to devise pro forma actions that might be taken after one of those severe stress events. Key among the potential courses of action in those situations is reinsurance. With reinsurance, insurers can drastically alter their retained risk and therefore shrink their retained risk to conform to their remaining capital.

REINSURER'S PERSPECTIVE

The investment and insurance losses that major reinsurers experienced in 2001 served as a wake-up call to the industry. Since that time, reinsurers have increasingly sought to coordinate their risk acceptance and retrocession strategies through the lens of ERM.

For many reinsurers formed following 2001, ERM has been a fundamental part of their business strategy. While the 2008 financial crisis was an unprecedented shock to world markets, reinsurers have for the most part weathered that storm—and the ensuing economic challenges.

In recent years, prudent risk management is increasingly seen as a differentiator. For example, since 2013, Partner Re had disclosed in its annual report risk limits for a dozen major risks along with its actual risk acceptance. Other international reinsurers have followed suit.

It's hard to know to what extent ERM drives reinsurer behavior, but as ERM has become further ingrained over the last several years, reinsurers have shown some different behaviors, even in the face of an extremely competitive marketplace as compared with prior decades. Catastrophic events have not created major dislocations in the market or, in general, threatened reinsurer solvency. Capacity has been generally available, and reinsurers are showing more discipline in avoiding overconcentration.

And, despite competitive pressure from alternative capital and the hardship of persistently low investment returns, analyst consensus places reinsurer return on equity expectations in a respectable range in the current economic environment, even in years with moderate levels of catastrophes. ■

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ENDNOTE

1 P&C Reinsurance Landscape article, *Reinsurance News*, July 2018.