InsuranceAsia News Allianz Re Roundtable

CONVERGENCE OF REINSURANCE AND CAPITAL MANAGEMENT

PARTICIPANTS

- **Amer Ahmed**, chief executive officer, Allianz Re
- **Wil Chong**, global head of life and health, Allianz Re
- **Philip Chung**, senior director, S&P Global Ratings
- **Frank Dubois**, partner, insurance and actuarial advisory, KPMG
- **Raj Juta**, partner, South-East Asia insurance sector leader, Deloitte
- **Vinod Krishnan**, Asia chief executive officer (treaty), Aon Benfield
- **Kenrick Law**, Asia-Pacific chief executive officer, Allianz Re
- **Moungmo Lee**, managing director – analytics, AM Best
- **Mark Morley**, managing director – Asia Pacific, Willis Re
- **Greg Solomon**, head of life and health international, Willis Re
- **James Tan**, chief executive officer, Tokio Marine Life
- **Holger Tewes-Kampelmann**, head of resolution management, Allianz Re
- **Kyung Won**, head of sales and strategy, Guy Carpenter

As the importance of capital management has evolved over the years, the role of reinsurers has also developed to meet these changing demands. To discuss this important topic and how it is affecting the sector in Asia, InsuranceAsia News and Allianz Re brought together some prominent industry voices in the region, comprising reinsurers, brokers, consultants and rating agencies.

Historically the industry has been focused on underwriting risk, but it is increasingly the case that a well-articulated risk appetite statement and a coherent capital management strategy are seen as the best practice — at least in more mature markets. In Asia, there is still opportunity for significant improvement in this area and brokers and reinsurers clearly have a role to play in leading this change.

In our wide-ranging discussion, this topic and many others came up for consideration as we considered the convergence of reinsurance and capital management. We began by asking Amer Ahmed how the approach to reinsurance has changed during the past decade or so:

Amer Ahmed: If I go back to when I started in the London market, reinsurance was the preserve of individual underwriting heads. Everybody would decide unilaterally what their risk appetite was and they would buy the programmes with their friendly broker, and the result was then fed into the overall corporate view. Today, it's about the interaction between finance, risk and capital managers, and the underwriters. If I give you the Allianz view, we take the position that our underwriters and operational heads of businesses should focus on writing good quality gross business and should leave it to the group functions to figure out capital, risk appetites and reinsurance.

Greg Solomon: On the life and health side, a lot of decisions have not always been based on what I call 'needful reinsurance', but are about access to reinsurance services — help with product development, pricing and so on. Reinsurance in general hasn't been well connected to companies' risk appetite statements, but I see that starting to shift now. Individuals who are active in the decision-making process are much more careful about being able to justify financially what reinsurance they're buying.

What's motivating this change?

Mark Morley: The underlying driver is the greater focus on capital and risk management from both regulatory and rating agency motivations, but it's not just that. Shareholders and investors are keen that their organisations fully understand their risk and follow best practice. In this part of the world perhaps we're not quite as developed, but we're moving towards a more Orsa [own risk and solvency assessment]-based evaluation and that can't be a bad thing.

Frank Dubois: We are really shifting from a situation where it was mainly about transferring the risk to a reinsurance company. Today, the key drivers have changed — it's not only about the type of event that may occur, but also the framework that you have and how reinsurance companies can structure a contract that can help to mitigate risk. Risk functions have really been enhanced significantly over the last two to four years.

James Tan: I agree with the point that reinsurance companies are playing a much bigger role to support us, but from our perspective the balance needs to be there. The level of competitiveness out there in the market is giving us a lot of pressure, so we have to have a very clear understanding of how we want to run the business and how we need to seek certain support from reinsurers to get us to where we need to get to. It's a delicate balance.

Ahmed: The whole risk-based approach forces us to think differently and encourages the right approach philosophically, but on the flip side it's adding to the challenges of reinsurers. As cedants take a more sophisticated view of what they're buying and why they're buying, it adds to the other pressures on margins and profitability that we have in our segment, so it becomes very tough.

Morley: It's worth bearing in mind that reinsurance is not the only solution to this. Increasingly, intermediaries regard ourselves more as capital advisers than just reinsurance advisers, so we need to make sure our counterparties on the reinsurance side understand that there are a whole series of solutions across the capital spectrum and that reinsurance still has some work to do to make sure it remains relevant in a far more educated, regulated environment.

Solomon: I've been speaking to a lot of actuaries around this idea of reinsurance and risk, and the reality is that a lot of them haven't spent enough time trying to quantify what the impact is from reinsurance. The 'vectors' I talk with them about are profitability, volatility and solvency. Everyone knows how to manage solvency, you've got all the capital management tools, and when it comes to profitability we know how to boost return on capital, but not enough people are talking about volatility. Yes, investors are looking at your solvency ratio, but their concern is increasingly how volatile it is and they seem to be leaning towards companies that have got better control, because that puts them in a really strong position to lower their target surplus and release some extra capital.

Kenrick Law: Greg brings up a good point in terms of the evolution of needs. What we observe is that certain markets are looking at protecting their operating earnings, so the earnings are not just affected by one line of business like motor or property. However, when things go wrong, as we observed in 2011, everything can go wrong at the same time. Actually, I'd be interested to hear how the rating agencies see all these changes.

Philip Chung: Within our analysis we do look at operating performance quite closely. If a company is good at what it's doing, has a brand name and the trust of the cedants, for example, they would be able to control their book, have a high return on equity and less volatility in those returns, that's the theoretical side. If insurers and reinsurers have had average or below average performance for the past five years when compared to peers, that gets penalised somewhat when we consider their competitive position, so that's factored in quite quantitatively.

On this point about solvency ratios volatility, how can reinsurance mitigate that?

Holger Tewes-Kampelmann: With the involvement and further develop-

Greg Solomon, head of life and health international, Willis Re

Mark Morley, managing director – Asia Pacific, Willis Re

Raj Juta, partner, South-East Asia insurance sector leader, Deloitte

ment of capital models it became clear that reinsurance should focus more on optimising the outcome of these models. Often, especially on the life side, it's not just about the insurance risk transfer but also investment risk transfer because that's an even bigger driver of the volatility of capital ratios, so when we look at reinsurance transactions for capital management we do a lot of fine tuning and structuring to improve the ratio itself and reduce the volatility.

Everyone talks about the soft market, the lack of growth, but AIG and Berkshire completed perhaps the biggest reinsurance transaction in history just a few months ago. Why did AIG do that? It is exactly to Greg's point. They wanted to reduce the volatility to get rid of this structured SIFI [systemically important financial institution] status that means they have to have another buffer of capital, so this transaction gives them enormous capital relief.

What we're seeing is a development away from the old bread-and-butter reinsurance business to far fewer transactions, but in bigger chunks that are very structured, more M&A-type transactions that are driven out of the finance function. But we should not drive this approach too far because a purely actuarial model can end up with something so optimised that the margin of error becomes very small — as we saw in the banking world in 2008. They released a lot of capital based on their Basel II model and then everything went wrong because they had this black swan event.

Solomon: And building on Holger's point, what's a bit different on the life insurance side is that companies are not clear on the breakdown of their overall risk appetite framework into the individual components — mortality, morbidity, investment, equities, interest rates. The problem with the reinsurers dealing with these risks is, yes, they can take on pandemic risks, earthquake risks and all these other mortality risks, and they can diversify that to a degree, but when it comes to something like asset risk, there's a limit to how much they can diversify. It's a systemic risk that affects everyone, so that's going to affect volatility, but it's much harder for reinsurers to take because it's correlated all the way through.

Ahmed: That's a great point, and the insurers and reinsurers are constrained by the same metrics, the same rating agency views and so on. They can diversify the insurance risk away, but if both the insurer and reinsurer are constrained the same way, the model doesn't work.

Solomon: There's also the issue of pandemics, which are not only a nightmare for life companies but for non-life companies as well. Some risks are exaggerated, but a major pandemic is going to make a mess of asset values, equity markets, interest rates and for a lot of financial groups that also have banking, you can imagine what that's going to do loan defaults. Even on the non-life side, travel and business interruption, for example, will be hit. It correlates everywhere.

Tewes-Kampelmann: It's interesting. When Sars happened, we thought about protection against these types of events and really looked at it holistically, not just on the insurance risk — and we saw the biggest problem was not the mortality losses, it was the capital markets. You have a drop in the equity market because everyone is afraid, you have some flight to quality and interest rates go down because everyone wants to have US dollar and treasuries, so to

Frank Dubois, partner, insurance and actuarial advisory, KPMG

James Tan, chief executive officer, Tokio Marine Life

protect us against this type of outcome we should not buy classic reinsurance for the mortality losses we have ceded to the market, but we should think about an extreme hedge on our capital markets side. However, while we need to consider the full breadth of instruments, and not just reinsurance, one of the big advantages of reinsurance is that it is the only tool accepted by rating agencies, accounting, regulators when it comes to risk transfer. There are a lot of fancy credit derivatives kind of transactions that can get rid of risk, but it doesn't help you if it's not accepted in the capital models.

What can be done to promote a more sophisticated discussion on the role of reinsurance?

Wil Chong: As Amer was saying, because the reinsurance and insurance companies are working within the same framework, we need to convince cedants that there's no free lunch. Someone has to pay for it at some point. As a reinsurer, we don't have a magic wand where we can just take all your bad risks and make something good out of them. Somebody actually has to find the right balance and pay for this stuff, and that's why the conversation with the CFO is quite crucial. And on the life side, most of our discussions have been with the actuaries and the CFOs, more so than on the P&C side.

Vinod Krishnan: One interesting development that I am seeing with a lot of the local companies in the region is that they are beginning to take the conversations around risk transfer even beyond CFO level. Our teams have had the privilege sometimes of addressing board members or risk committees, which means that discussions on matters such as how firms can achieve reductions in volatility, the associated benefits and the various capital options available to them, are at a completely different level. Risk transfer is not just a transactional reinsurance piece; it's more a balance sheet consideration.

Morley: The board's ultimately responsible, so as regulatory and rating agency expectations change, the fundamentals of having to understand the risk you're underwriting suddenly becomes relevant at board level. It's now at the point where the level of engagement has helped the conversation in terms of finding solutions rather than just talking to the reinsurance teams and stopping there.

Chung: The regulators are able to push this a lot more than rating agencies — we really don't have that much power. If the regulators don't want an RBC... well, we can come in with our models and so on, but what does it mean at the end of the day? Regulatory regimes in the region are getting more risk-sensitive and we find the more sophisticated companies are increasingly looking at optimising their use of capital.

Moungmo Lee: CFOs are very number-sensitive people and when it comes to asking shareholders for capital they know exactly how much it costs; if they go to the debt market, they know exactly what the cost is; but when you talk about reinsurance it's very difficult for the CFO to see the cost of it. If the product could be redesigned so that costs can come up front with high certainty, it would be much more appealing to the finance people.

Tan: There's a lot of conversation at least from direct companies about new business, but they tend to ignore the back end of it, the in-force business, how that should be managed. What would be helpful for us would be a strategic conversation with a reinsurer or a consultant to take a more holistic view of the company and how those elements work together. I don't think we're having enough of that conversation today.

What about the role of capital management in financing growth?

Chong: In the minds of our cedants and their different stakeholders, one of the more important objectives is to grow the portfolio. Obviously capital management is another tool where you can free up capital and do that. Especially on the life side, there are a lot of transactions where capital management is a way to fund acquisition costs, whether from in-force portfolios or future new business,

Kyung Won, head of sales and strategy, Guy Carpenter

Vinod Krishnan, Asia chief executive officer (treaty), Aon Benfield

Philip Chung, senior director, S&P Global Ratings

which is an interesting area.

Raj Juta: That's very important, because companies in mature markets such as Singapore need to find growth elsewhere in emerging countries, so they want to free up capital in their home market and see how they can expand overseas.

Morley: That's a really good point. Not only is diversification a sensible thing for insurance companies to pursue, but my understanding is that regulations are moving towards the recognition of diversification as a benefit, so there are multiple reasons why that makes sense. But it has to be 'quality' diversification.

Lee: Definitely. I don't like people putting out press releases about the benefits of diversification without a qualifier. A lot of national and quasi-national reinsurers we see in this market got the rating to do overseas business, but I haven't seen anyone yet making any money from it.

Morley: And that's absolutely key. You need to have the competence, capability and capacity to access quality diversified business or it's just not going to get the recognition. There are methodologies and approaches that can give them that.

Ahmed: Isn't that a situation where the models encourage people to do what they shouldn't?

Ahmed: I remember a Bermuda-based company, a pure property cat writer, complaining that they were getting punished by the rating agencies for being a monoline cat writer. They were good at what they did, they wanted to continue doing that, but they felt obliged to go out and play the field.

Morley: Yes, but imagine if Allianz had given them access to a broadly diversified book of global business, it might have been an interesting conversation.

Ahmed: Absolutely.

Solomon: It's also quite interesting to talk about why companies are managing their capital — they're not just randomly freeing it up, they're trying to invest it. But are they thinking about that in the right way? There's a difference between companies' long-term aspirations and their immediate aspirations and, in my mind, the correct way to do that is to have long-term aspirations, layering on top of what's going on now. For example, a company may go through a few bad years and the analysts are penalising them, so they need to look at smoothing their results and letting the markets relax a little bit. But they need to do this without losing focus on what their long-term objectives are, even as they recognise that their needs have changed in the short run.

Kyung Won: Around Asia Pacific, the range of reinsurance knowledge is still very wide. You've got mature markets where CFOs and board members understand the holistic ERM [enterprise risk management] perspective and use of reinsurance, and you've got the other end of the spectrum where people don't understand what reinsurance is and think it's a short-term thing — they want to use reinsurance somehow in this soft market environment to boost earnings and cover up bad underwriting rather than having a proper capital discussion. It's just leaving it up to you to somehow smooth out the results.

Is the industry in Asia doing a good job of articulating things like risk appetite?

Holger Tewes-Kampelmann, head of resolution management, Allianz Re

Wil Chong, global head of life and health, Allianz Re

Solomon: We're getting better at it, but a lot of companies simply do not have risk appetite statements. Risk appetite is largely the engine that drives us — what we will write, what profitability we will tolerate, what loss leaders we might accept, it's all of that — but that engine is hidden because it's part of our competitive edge, so companies aren't sharing a lot about their risk appetite as explicitly as they could — even internally.

Ahmed: You mentioned competitive advantage, but I wonder if I would turn that on its head. A company could say to its stakeholders, this is the profit profile and volatility of one strategy we could follow, or we could follow a more risky strategy and give you a potentially higher upside with commensurate downside. In my judgment, there's a not a very open discussion about what options we have and ultimately what are the preferences of investors or other stakeholders.

Let me give you an example. Imagine a company that consciously takes a higher risk appetite because it's trying to generate a higher return. It shouldn't be punished for having a relatively outsized loss, because that was part of the plan, but my sense is actually that would be discounted. 'You went through the top of your programme, that's got to be a bad thing.'

Dubois: What you're talking about is definitely more mature in Europe. In Asia, when I see a risk appetite statement it can range from a very high-level type of statement where you can't do anything with it, to something that is so granular that you also can't do anything with it. It's really about finding the right balance and having a clear strategy and execution linked to the risk appetite statement, and then the business plan and capital management. That's how it should work. But where do we have that? In Singapore, we are starting to see such frameworks with the new MAS Notice 126 on ERM and Orsa. But we don't yet have such detailed frameworks in other parts of Asia, not even in Hong Kong.

Solomon: Anyone can model an insurance company and its results, its balance sheet and its P&L. The question is, how do you constrain that model? For example, a company might be using a 40% quota share, but because they haven't been very clear within the details of their risk appetite statement, they can't show you whether a 50% quota share is better or worse, and that's evidence that your risk appetite statement is not good enough.

Won: Clients also have trouble linking the metrics and understanding the trade-offs, so when you think about reduction in volatility versus another metric, it all sounds sensible, but then how do I choose between the best options? One has high volatility reduction and one has high capital reduction. How do I choose? Clients really struggle with that because, first, there's a lack of transparency within the organisation about the whole appetite discussion and, second, there's no real understanding of who owns the appetite statement. Is it just the CEO and the board members? How does it translate back to me as a buyer making the decisions? That's still quite prominent in our market.

Krishnan: We can evaluate the risk versus reward options, but someone has got to take the decision and say: 'It's my call.'

Chung: If there's a big loss, one of the questions that can be asked is: 'How does that fit within your risk appetite statement.' The ones with a good statement would be able to say: 'This is what I gave you last year, this is the breakdown and it fits right in here.' In Asia, apart from not having sufficient conversation, the models are basic, the statements are lacking. When someone comes up with the risk appetite statement, the first question is: 'How involved is the board?' If it's just an ERM department looking at it, it's a good move forward, but when you see the boards getting involved and actually tracking risk KPIs [key performance indicators], the credibility of the risk appetite statement is a lot higher.

Juta: I think it also depends on the quality of the board. If you have a board that doesn't have the skill, they will

Kenrick Law, Asia-Pacific chief executive officer, Allianz Re

Amer Ahmed, chief executive officer, Allianz Re

Moungmo Lee, managing director – analytics, AM Best

just approve what the ERM specialists give them. It's about having people of sufficient quality to challenge those statements, so that's the key for me.

Ahmed: the challenge I see is that, even if you have a reasonably well articulated risk appetite assessment, translating that from something somewhat abstract to something really operational is extremely difficult.

Dubois: That's the key: how to make it practical. Risk management has to be able to explain the results of the models and to provide comfort to the management and to the board, although those models can sometimes be very complex. So the question is how do we make the outcomes understandable for the key stakeholders to make decisions?

Solomon: Regardless of what is being said on one side of the business, the way it's implemented is a different thing. So culture is a really important thing to manage, which is why the board has to give that steer on how you set off reductions in volatility with reductions in profitability. There should be clarity on that, otherwise they're driving blind.

Tan: It is hard. We do this every day. A lot of it is communication to the staff, to the management team, working with the board. There's a sense that if we put something together as a guideline or a rule, in theory everything should work well, but there are elements when you have to make trade-offs and this is where the business judgment comes in and where we've got to make a call. You can't get it 100% right and you're always subject to lots of different pressure from stakeholders.

How is the abundance of alternative capital affecting conversations with cedants?

Morley: In a market that is as competitive as it currently is, our cedants are looking around for the best possible deal, but all it means for reinsurers is innovation around product supply and offering, and that's supported by a lot of what we're talking about around the table. It's a challenge for both insurers and reinsurers. It's certainly not as simple as just saying that this market is fantastic for insurers. Most of our clients recognise that there's a requirement for long-term relationships. We see it encouraging a much more focused approach to product innovation, product offering and the sorts of conversations we should be having with clients. It means that your differentiating in the market around your capability, which I can't help but think is a good thing.

Ahmed: The reality is that for the foreseeable future we're just not going to see the cycles that we've seen in the past. It looks like it's going to continue in this vein and we as an industry have to figure out how we're going to operate in what Pimco used to call the 'new normal'. It's not about sitting and waiting for the next hard market — it's not going to come.

Krishnan: The challenge we face is that globally there is a large amount of capital and ample risk, but we're currently not matching enough of that risk to the capital available. So the situation we have is that there's just a lot more capital chasing largely after the same vanilla business without looking at how to innovate to capture some of the exposed risk out there and bring it into the insurance ecosystem.

Ahmed: I think it's Aon that does the study on the primary side, with CFOs

and perception of risks. Fire is not high on that list. If you look at the top 20, there are a lot of risks that corporations are worried about but we're not providing solutions for. We have to wake up and ask how we address those needs. We can do a better job of helping people understand the cost of risk and really help them figure out the best way of financing that risk, and then bring it to the insurance level. The opportunities are there, but there are also some challenges. It's difficult to take on new risk given the regulatory environment.

How are you going to model cyber?

But we also need to be more active with governments or quasi-government entities to look at risk from a macro point of view, because it's not all going to be solved by selling more insurance policies to individuals or corporations. We need to increase the pie, not fight over the same pie.

Krishnan: I think that as an industry we haven't done enough, if we want to be self-critical. We go after the commercial business, where the pie hasn't grown. The P&C reinsurance premium pool hasn't grown in the past 10 years; in fact it's going the other way. We're going after the same business with so much more capital than 10 years ago, without thinking where we can deploy that capital more effectively. As an industry, we should be doing a lot more collectively.

Ahmed: Another thing that is ironic is there are risks that corporations carry, but as soon as they get transferred to an insurance company, they get a risk charge. It's an anomaly. There needs to be some thought to say: 'Well, why is it now Allianz has got this risk, somebody's interested in it from a regulatory or rating agency point of view, but if it had been left uninsured it was on nobody's radar screen.' There's some irony in that. If we help corporations understand, we really can bring a lot to the table rather than just push an insurance policy.

Solomon: Just to return briefly to alternative capital, so far the life industry has been less affected by it because you have to engage for longer durations. But we're seeing more organisations setting up securitisation funds with assets coming in at three-year duration, five-year duration, and beyond — so we are going to see an impact on the life industry. I don't think instantly, but it will happen more and that will put pressure on rates on the life side, which may make things tougher for the large reinsurers with a big infrastructure to support.

Ahmed: I see that as an ultimately positive development. As an insurance/reinsurance industry we have a pretty good appreciation of risk, we have a lot of capital, but if somebody else is providing capital that is more attractive we should harness that. We can still acquire risk, take on that risk, package it, and if our equity is the most attractive place for it to be held, then we should hold it as an insurer or as a reinsurer, but if there's somebody else who can provide that capital more cheaply, we should make that available because in the end we've got to make this as efficient as possible so I don't see it as a threat because we've got the risk intelligence.

And just to end on a key and positive note, there are clearly lots of opportunities out there, but one of the points we've heard from the broker side is that this isn't about one company or one broker solving this, it's about a collective effort from the industry. The education of the community at large is an industry-wide responsibility and we should figure out ways to do that — and then we can fight about how we make money out of it later.