What future for cedant/reinsurer relations?

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The scarcity of adequate cover for clients both at the level of individual risk and at the level of catastrophe accumulation has boosted the creation of new forms of insurance and reinsurance which, in their historical development, we can identify from Captives to Derivatives, with various more or less sophisticated formulas in between.

Insurers and Reinsurers must achieve a positive technical result for their long-term success and, save in exceptional circumstances, this success cannot be achieved if the rate of growth is too fast and too unrealistic.

Reinsurance has failed and is failing to perform its proper institutional role of contributing to the balance of the results of direct insurers, having departed from this basic principle.

Particularly, in the past few years, reinsurance has, on the contrary, often become a destablishing element, and present attitudes are confirming that it will not change.

Cedants have experienced years in which available capacity has risen and prices have constantly fallen. They themselves have often helped to create this capacity. We all recall the abuses against «innocent capacity», the years of what is known as «cash flow underwriting», the «retrocession pools» and the London Market Excess of Loss specialty.

All these were aberrations camouflaged by so called theoretical formats to justify the subscription of large volumes of premiums, with the aim to satisfy the need for size so much in vogue in the 1980's. All that it took were a few sharp rises in the frequency of claims for all these structures to come crashing to the ground.

My impression is that we have not learnt too much from the experience and the same scenario may soon happen again, although to a lesser degree.

Today the questions that the market is asking itself are:

– The right to exist of «classic» reinsurance.

– The possibility of survival of small and medium-sized reinsurers.

– The future relationship between cedants and reinsurers.

I would also add that it would be appropriate to ask ourselves how better to serve our client, the insured.

Despite this, the capacity available today in reinsurance is not meeting market demand, so that the end user is not being given adequate service and rates are again going down.

The primary objective to be achieved in reinsurance, and one that should not be lost from sight, is that the cedants and the reinsurer should work in close cooperation to satisfy the client's needs for cover as best they can. Failure to achieve this aim would represent the maximum setback.

If the **solidarity** between the cedant and the reinsurer that has been partially lost over the past few years were to be restored, as it should be, the management risks of reinsurance would be sharply reduced.

The **solidarity** that both the cedant and the reinsurer both need may also take diversified forms, which - without selfishness - can give new life and imagination to the forms of cover.

Solidarity and **continuity** are the **right** and **duty** of a cedant deciding to set up reinsurance programmes in the light of the principles indicated.

If the market were to deny cedants this right, they should not hesitate to create their own forms if solidarity.

This idea might seem provocative to my reinsurer colleagues. One idea, for example, is that there might be systems for the interchange of capacity among cedants of different countries or Areas, managed with the advice of a professional reinsurer.

To be even more provocative, the same idea could be extended to non-proportional cover, for which companies from different countries could create a consortium for the acquisition of cover and I am afraid we are already experiencing some example of this tendency (i.e. The Catastrophe Risk Exchange).

The recognised salient features in defining the level of the reinsurer are:

– Solvency.

– Continuity.

– Services.

Absolute amount of Capital and «Rating» are now becoming a more popular form of assigning solvency levels.

Besides the first approach however evaluation criteria should abstract from size and sterile classification.

These factors should be related with a detailed examination of accounts, familiarity with the reinsurer, the structure of its portfolio performance, and particularly its Underwriting policy and criteria in the past.

Continuity is a factor to be considered with extreme care in this period in which it has become extremely vulnerable because of the objective difficulties of the market.

Not a few cases may be cited where the interruption in the continuity of the service arose unexpectedly and against the will of the management itself.

The scarcity and high prices of reinsurance capacity have stimulated the creation of new reinsurers.

Although they are making a contribution towards solving the shortage of capacity, they do not guarantee the continuity an insurer needs for the development of its business.

So long as we operated in tariff markets or well regulated markets, it was relatively easy to determine the price of reinsurance, based on the original premium, from which a percentage was deducted as remuneration for expenses. Liberalisation or deregulation brought about a gradual deterioration in results and a reduction in margins.

In this context, the reinsurance price is determined in the light of experience and as an attempt to maintain adequate technical conditions, differentiating from the original premium and therefore establishing the price with criteria other than those used by the direct insurers.

In non-proportional cover, the reinsurance has always offered a price based on its own evaluation criteria.

This is even more evident in catastrophe cover.

Cedants cannot exempt themselves from paying the **proper price** if they wish to obtain a good quality product being bought, and if they wish the reinsurer's shareholders to maintain or hopefully increase, their commitment. Unless there is an adequate **return** on this capital, it cannot be available.

Cedants cannot ask reinsurers to offer a full range of services and consultancies, maintain the necessary number of employees only to write difficult classes of business.

At the time of the latest natural disasters the involvement of insurers was very modest, and even more modest was that of reinsurers, compared to the economic size of the original losses.

At the end of the eighties and the beginning of the nineties, we have observed a rise in the frequency of natural disasters, at least as regards the insurance consequences. For the first time direct companies and reinsurers have seen with their own eyes the potential exposure of their portfolios. All this has happened without any of the worst-case scenarios imaginable having occurred.

This is the reason for what I would call the uncontrolled haste to adjust prices, limit exposures and to go into theory in detail to identify the causes and probabilities in order better to define the damage estimates. All this dynamism is especially opportune, and we should not try to skimp on the help that new technologies too can offer us in these efforts.

Collaboration between public and the private institutions should take the form of practical protection projects that create a safety net, guarding against both the consequences of a series of catastrophes over a brief period and guaranteeing the capacity for other possible catastrophes.

As I mentioned the dimension of the problem is terrifying and we do not have adequate answers; preliminary progress might be made by accelerating the process of making it easier for companies to set up special reserves in countries in which this is not yet allowed.

Unfortunately, in a situation of heavy demand, the market seems once again to be moving inexplicably towards reducing prices rather than improving its services.

To avoid destablishing crises, cedants must acquire a long-term strategy, as their own insured do. Just as they would not accept requests for discounts from an insured who has been claim-free for several years, they should not ask for reductions in cover after a few claim-free years, or turn to markets that are prepared to grant them.

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New systems of cooperation seem to be establishing between the cedants and the reinsurer with regard to the management of portfolios. The winning reinsurers could, in fact, be those that, because of their SIZE will be able to make technology available to the market or those who, because of their connections with Direct Groups involved in reinsurance, can have the same access to major technological resources.

«SIZE» is not to be interpreted as capacity for absorbing or buying other companies, but as capacity for being an international player and providing adequate products and services to the Clients.

The classic system of COMMON DESTINY with cedants will still be applicable, but only with regard to those cedants who agree with this planning; if they are convinced of the necessity of splitting the profits with their own reinsurers, they should still be able to create a nucleus of capacity which will allow them to guarantee the three essential factors.

The direct companies which, by their own choice, do not agree with this planning, will undergo more accentuated fluctuations in the cost of their programme of reinsurance depending on the market situation.

Although I do not discuss the legitimacy of this second option, I remain convinced that the key to an optimum solution of reinsurance problems cannot leave out of consideration the common destiny with their reinsurers.