

Reinsurance in an evolving risk landscape: Implications for GCC-based insurers

The risk landscape is in full flux, with the financial crisis adding another layer of dynamism. Stakeholders are increasingly sensitised and placing much greater scrutiny on insurance companies. How do these developments affect the role of reinsurance as a core element of insurance companies' risk management? And what are the implications for insurance companies domiciled in the Gulf region - companies which traditionally display a heavy reliance on reinsurance? **Dr Kai-Uwe Schanz**, Principal Partner of Dr Schanz, Alms & Company AG, Zurich, examines these issues.



The "PEST" paradigm offers a powerful illustration of the dynamics which are characteristic of today's risk landscape: Since the demise of the Soviet empire, political ("P") risks have reached a new and continuously growing dimension. Terrorism remains virulent and is spreading to ever larger parts of the world. Political instability keeps aggravating as historical poles of power continue to erode.

The current financial crisis and the subsequent severe recession have also highlighted the new quality of economic ("E") risks in today's reality of globally integrated flows of goods and services. The risk of cross-border contagion, for example, needs to be reassessed. Social ("S") developments, eg, the rapid rise of middle classes in countries such as China, India and Brazil, have led to improved standards of living and changing patterns of insurance demand, for example an increasing emphasis on liability covers. And last but not least, the rapid pace of technological ("T") innovation (eg the progression of nanotechnology) is reshaping the risk landscape.

More demanding stakeholders

At the same time, in light of the financial crisis, stakeholders are placing greater scrutiny on insurers: Investors are seeking higher levels of comfort before committing capital, policyholders are becoming wary of their insurers' claims-paying ability, regulators are pushing towards higher risk-based capital requirements and the general public is wondering whether insurers may pose similar risks to the financial system as the banks.

Cost-effective risk management through reinsurance

These dynamics, and in particular the integration of global financial markets, require insurers to make an even more efficient use of their capital. Further, regulators are pressing for the use of internal risk models, covering Asset-Liability management, solvency testing, corporate planning and risk management. The latter also includes the optimisation of reinsurance programmes.

Traditionally, the purchase of reinsurance is the most cost-effective short-term way for an insurance company to grow its business while mitigating the associated risks. Alternative routes include the pursuit of a less risky investment strategy, the raising of capital or changes to the underwriting strategy (eg, by de-emphasising capital-intensive lines of business).

Going forward, under Solvency II and similar frameworks, the internal model will be the basis for designing a strategic reinsurance programme which helps protect an insurer's overall capital, takes advantage of diversification effects and ultimately leads to a reduction in risk-based capital and the total cost of capital. And far-sighted reinsurers are well-advised to assist their clients in determining what is needed to minimise the total cost of capital – not more and not less.

Implications for GCC insurers

Traditionally, domestic insurers in the GCC display an extraordinary reliance on (foreign) reinsurance. On average, cession rates range from less than 40% in Saudi Arabia to more than 60% in Oman, but can run as high as 100% for "mega risks". Therefore, the region's reinsurance market amounts to a sizeable US\$ 4.5 billion, close to 50% of primary insurance volume.

This pattern of low risk retention reflects domestic insurers' limited capital base and insufficient scope for risk diversification within their relatively small home markets. However, the reliance on reinsurance is diminishing: the aggregate cession rate for the GCC region declined from 59% in 2004 to 49% in 2007 as regulators have started to impose higher capital requirements, domestic shareholders question the cost-effectiveness of traditional reinsurance purchasing strategies and the share of (compulsory and largely retained) medical business is expanding steadily.

The GCC region will be no exception from the global trend towards an ever expanding risk universe – not just quantitatively but also qualitatively. Reinsurance, no doubt, will remain a cornerstone for the regional insurance markets' future development. However, also in the GCC region, reinsurers will feel an increasing pressure to offer solutions which help ceding companies minimise their overall cost of capital in a more demanding and sophisticated global and regional risk universe.^M

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