The Changed Face of Reinsurance

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1. Introduction

This contribution to the 10th Anniversary Issue of the "Geneva Papers" attempts like Janus to look in two directions. It aims to highlight some aspects of the reinsurance scene today and to contrast these with the situation before the last war. The past forty years have been a success story for this hitherto little known international financial service, which has managed successfully to fulfil its commercial role at a time of unprecedented technological change entirely transforming the business environment in which it originated. The function of spreading the high valued target risks and accumulations of exposure to catastrophic events among carriers internationally must obviously deal with major uncertainties and the problem of risk at its most capricious. The science of probability becomes progressively more inexact as the risks with which it is concerned become fewer and larger. Reinsurance, which deals at the upper end of this scale, has by and large coped with the problem with outstanding success.

We were taught that jobbing backwards is an unproductive and even futile exercise. However, to draw comparisons with the past can often help to bring the present into better perspective, and to remind ourselves of former practices may also be useful in the solution of present problems. In 1938 reinsurance was among the least known activities in the City of London, even in insurance circles it was obscure and regarded with some understandable suspicion following its dismal post first world war performance.

2. The new reinsurers

The rise of reinsurance to its present fashionable estate, which began in the 1960s and has continued up to present time, can truly be described as dramatic and has far outstripped the mushroom growth of reinsurance companies that occurred in the early 1920s for entirely different reasons. This earlier explosion had its origins in the need to fill the void left by Germany's post-war economic collapse. Forty years later in the political and economic climate then prevailing, reinsurance offered by far the easiest way of entering international insurance and provided a means of achieving growth in stagnant domestic markets. Furthermore, it did so at a time when nationalistic attitudes locally discouraged direct insurance operations by foreigners and when the expense of such labour intensive activities were in any event becoming virtually prohibitive.

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The overcrowded market that has resulted, though somewhat bruised, remains at least for the time being, effectively intact. By the nature of its generally powerful financial origins this new capacity is unlikely to collapse in the same way as those who were involved in the capacity explosion of the twenties, where the withdrawal of virtually all the new reinsurance companies took place on account of financial embarrassment with but a few notable, and still surviving, exceptions. Disenchantment with the record of performance and a poor comparison with the return on other available investment outlets, is more likely to trigger off the shakeout in the reinsurance market that is foreseen by many, but is difficult to predict or to time with any degree of accuracy. Not until this has occurred with the market harden its technical underwriting attitudes.

3. Market control

Among the sharper contrasts between pre-war reinsurance operations and the present day, is the current system of government supervision. The time has long since passed when but a handful of staff at the then Board of Trade was concerned with receiving and filing returns from insurance companies. Their role was more concerned with recording information than with exercising supervision, but several Acts of Parliament and one or two notorious insurance company collapses have changed all this. In any case the United Kingdom's accession to the EEC would have ended the era of laissez-faire and reliance on self-regulation in the market affairs of insurance and reinsurance companies. Currently the whole issue of supervision is both active and contentious in the community with a wide divergence of view as to the proper role of the authorities and how this should be exercised.

Deep differences have emerged in the national approach to reinsurance control, mainly for historic reasons, distinguishing the different national, commercial and legal approaches in the EEC to the business of reinsurance. These divergent attitudes highlight the immense problem that confronts officials charged with protecting the public interest, without inhibiting an important and lucrative international trade in invisible exports. In fact the task is effectively an impossible one without intergovernmental co-operation on a virtually world-wide scale that is almost unheard of in the political climate of today. Reinsurance must be free to cross frontiers without undue restrictions and even throughout the period of stringent exchange control regulations in post-war Britain, reinsurance could be freely transacted the world over, providing the claims were paid in the currency in which the premium had been received.

Retrocession follows reinsurance and probably through several generations of carriers, and across more than a few frontiers until the risk is spread sufficiently wide for it to be carried without undue burden by the community of international reinsurers. Each reinsurer will according to his own standards of security be satisfied with the financial integrity of those who directly give him protection. But beyond this first tranche of cover, neither he, nor the broker to whom he may have deputed the task, will know with whom the next level of cover has been entrusted, nor will they have had any say in the selection of the carrier. In these circumstances should one domino fall no-one can be certain where the last one will finish. Various systems whereby the

authorities might more effectively achieve their purpose have been proposed, from different types of indemnity pool, modification of the Policyholders Protection Fund idea adapted for reinsurance operations and variations of the Protection and Indemnity clubs. No suggestion so far made seems however to have any likelihood of achieving sufficient commercial or technical support on the required international level to achieve the objective of adequate security without putting the industry into a straight jacket and thus inhibiting cover for today's highly valued and complex target risks.

The only method of control likely to be feasible involves a degree of international political co-operation, which in the present climate of international politics is surely unattainable. Administratively however it would be relatively easy to establish standard financial requirements for reinsurers on which a licence to operate would be issued. If such a formula could be agreed and accepted sufficiently widely by supervisory authorities the world over then an international register of admitted reinsurers could be established. Each authority would examine and issue licences to those reinsurers within its own jurisdiction able to meet the agreed criteria and would recognise licences granted by other authorities who were signatories to the agreement. Reinsurers unable to meet the standard would be without licences and would suffer the penalties of non-admitted status. Eventually many of these would no doubt fade away, but if a sufficiently wide international register of admitted reinsurers could be established the lack of their cover would not be missed. It would of course be idle to imagine that such a register would prevent future reinsurance collapses. The causes of reinsurance failures are many and various, but such action would demonstrate determination on the part of the authorities internationally to monitor the security of the reinsurance chain.

An effective system of control over the financial standing of reinsurers operated by supervisory authorities internationally and backed up by self-regulation in technical matters by reinsurers themselves would greatly assist in restoring stability to the indispensable transaction of the international reinsurance service. Furthermore, it would be welcomed by established reinsurers and responsible brokers who fully recognise the dilemma of the supervisory authorities and who would willingly support any step designed to establish, maintain and monitor the highest level of financial standards for reinsurance operators consistent with allowing them sufficient freedom to transact their complex business.

4. Professional status

Viewed from its present position of much publicised activity, it is hard to imagine how obscure and little regarded reinsurance was in the London market in 1938. Not only were the few professionals very small in financial and all other terms, and smaller than almost all their client ceding companies, but their service was regarded as being somewhat in the nature of a necessary evil. Specialist reinsurers were excluded from full membership of market associations and were generally considered as a lesser breed without the law. Almost the only illumination in an otherwise dismal professional atmosphere of condescension was the high international standing and established reputation of the Swiss Reinsurance Company of Zurich and the rise to the present

position of eminence which the profession now occupies, owes much to the principles on which this greatest of all professional reinsurers had then conducted their business for three-quarters of a century. Against this background it is easier to understand why it has taken so long for the issue of self-regulation, in the reinsurance market, to become active and indeed why it was not until 1969 that reinsurers got together to form their own association, the ROA. Now that self-regulation to reinforce official supervision is an urgent necessity, to preserve a market sufficiently flexible to perform its task, there is an established platform from which this can be launched. If this issue is not tackled, or should be compromised, then there is the real prospect of over-reaction by the authorities in pursuit of their highly problematic objective of protecting the public interest with consequences that must be distinctly detrimental to reinsurers future prospects.

Codes of conduct whilst notoriously difficult to establish and administer in a financial service industry such as reinsurance, can nevertheless with resolution and good-will be introduced successfully. But they must operate by exerting control over the basic processes of trading and have the ultimate sanction of denying these facilities to those who transgress accepted codes of conduct willingly subscribed to by members of the market.

Those who control London's various insurance markets from elected positions of authority, having powers delegated to them by the members are clearly those in the best position to exercise discipline over rogue operators and judge the rights and wrongs of specific situations. In recent years there has been a reluctance amounting to weakness and irresolution by the leadership of some insurance market technical associations to use the powers they have positively and effectively. Without a determined leadership ready to exercise authority in a complex business such as ours, it becomes all too easy for malpractices to become established and even eventually to be hallowed by custom and regarded in the market as being like the poor, always with us and therefore inescapable.

There are already some important London insurance markets that have the practical means of withdrawing the capability of their members to trade by denying to them use of jointly shared administrative services essential to operations in this field. Today the reinsurance market in London, where virtually all the major reinsurance operators are represented, needs a similar sanction by which it can enforce adherence to its codes of practise by the threat of withdrawal of essential services supplied jointly to all its members. It is probable that the basic means of achieving self-regulation in this way are presently available in the London market and could be harnessed to this end if there was sufficient determination and good-will to do so.

5. Administration

To individual reinsurers the impact of administrative change on business methods has been dramatic to say the least. Before the second world war the high desk, the hand written ledger and even perhaps the quill pen were still to be found in some offices. Prior to this there had been a stability in the systems employed to administer

reinsurance operations that was as old as the business itself. Bordereaux, provisional and definite, treaty and facultative and the reporting of losses paid and outstanding were the standard accompaniment of all reinsurance transactions and involved literally mountains of paper and armies of processors to maximise and control commitments and to check the elaborate manually produced multi-currency quarterly accounts.

Since that period the introduction of mechanisation to reinsurance procedures has involved a succession of quite different systems spanning first Hollerith and Powers-Samas punched card methods to the modern electronic computer systems of today with modifications and new ideas arriving all the time.

Each new system had to be learned and applied to the business and adapted to a transaction often initiated by ones less well versed in the complexities of reinsurance than those at the receiving end. At no time throughout each period of transition involving many changes in practical methods has any attempt to standardise procedures met with any success at all, in spite of the demonstrable saving in costs and simplicity of operation that would obviously have been achieved.

This lack of administrative co-operation between the parties involved has had other unfortunate consequences, it has reduced the flow of meaningful risk information so laboriously transmitted formerly by way of bordereaux to virtually nothing at all that can be used, for example, to identify accumulations on target risks or the exposure to natural catastrophes. Reinsurers are now effectively obliged to rely for the estimation of their liabilities and subsequent protection on theoretical calculations based on limits of exposure which are notoriously unreliable to assess. It is all the more surprising that the abandonment of such a basic discipline in the business should have taken place at the very time that the technical possibility of providing this information economically through the electronic process should have arrived, since the basic information needed by reinsurers must also be available to direct insurers themselves for their own essential purposes.

It seems certain that the present high rate of change in electronic innovation will continue or even accelerate. The consequences to individuals in the reinsurance business are not however easy to predict. Already much of the basic material, such as bordereaux, used for the training of technicians has vanished from the scene, making it far harder to learn the elements of the business. Whatever can be accomplished by electronic process must still be fully understood and controlled by those whom it services, and they will be increasingly concerned more with decision taking than with clerical routine, since this latter function will progressively be absorbed into computer operations. Technical training will therefore need to be highly organised in a decreasingly labour intensive operation, but one which if it makes full use of the potentially available technological means of transmitting business information world-wide could achieve a vast improvement over the methods used today.

Here again it is a question of co-operation and having the will to introduce standardised systems for the sake of simplicity and low cost operations. But judging from the record of unwillingness and the lack of co-operation between markets and the companies themselves comprising those markets so far evidenced in international reinsurance history, there can be little optimism for achieving anything like the full potential that is available in this field.

6. Client relationships

If the principles of reinsurance marketing and the philosophy of the reinsurance client relationship have remained relatively unchanged, methods have none-the-less evolved in a number of subtle ways since the end of the second world war. Reinsurance brokers were even rarer than reinsurers in those days and the "Classic Reinsurance Relationship" was one formed by personal introduction directly between ceding company and reinsurer in what eventually became in effect a partnership arrangement.

Direct personal contact was rightly regarded as a vital part of the reinsurers strategic aim of underwriting the underwriter, whose skill and qualities could not be accepted at second hand. So closely were the fortunes of the direct underwriter followed in the joint venture that nothing other than a close personal association could produce the necessary degree of trust and confidence in the business policy and the practices of the ceding partner whose commitment on most shared risks was almost certainly less than that of his reinsurer.

Generally speaking the great majority of contracts were designed to generate an identity of interest for both partners to the reinsurance treaty in the eventual underwriting result. Both parties stood to benefit from its profitable performance and both would suffer in the event of an underwriting loss. This mutuality of concern over the underwriting outcome was healthy in a variety of ways. It gave to the reinsurer the position of a "confidante" and adviser which had already been prepared by the initial direct personal contact established between the partners. "Following the fortunes" was the guiding principle of the business association and the mutual self-interest of both parties lay in sound underwriting practise since their prosperity depended on this.

In the thirty years that have followed the war and seen the formidable build-up in the scale of international reinsurance operations, there have been subtle changes in the "Classic Reinsurance Relationship". The traditional identity of interest in the underwriting outcome of reinsurance arrangements has steadily diminished with the increasing employment of non-proportional covers, which has extended more and more to property business from its more customary use for liability cover and at the same time we have witnessed a very powerful growth in the role and influence of the intermediary broker. Overcapacity has been a further cause of reducing the mutuality of interest since competition has weakened the determination of many reinsurers to maintain sound technical standards. The resulting, though gradual, replacement of reliance on the principle of joint interest to ensure profitability in favour of purely commercial objectives has cost the industry dear. The seductive attractions of short cuts in the technical handling of the business on the grounds of saving expense and administrative convenience have proved irresistible under strong pressure from those most likely to benefit and reinsurers have in the event deprived themselves simultaneously of basic information on their liabilities, and the effective means of monitoring the technical handling of the business ceded to them.

This is not to deny the important role of the broker in reinsurance affairs, nor to diminish the essential value of non-proportional covers, but the fact remains that the reinsurance process never did provide reinsurers with many checks and controls over

the handling of the business by ceding companies and they simply could not afford to loosen their grip any further. So soft has the over-expanded reinsurance market become that pressure has eliminated too many of the traditional safeguards in the system that remained.

Dependence on purely commercial considerations is not an altogether satisfactory basis for such a long term business association as reinsurance. The exploitation of reinsurance cover to the exclusive advantage of one party led in fact to making reinsurance illegal in this country for a century which only ended in 1864. Goodwill is needed in any long-term business arrangement and nowhere more so than in reinsurance contracts. There are signs that this precious asset for all lasting associations is tending to be disregarded and this is both short sighted and dangerous. No sensible operator wishes to work in a market where the laws of the jungle apply and where commercial considerations are not tempered by goodwill and those other factors that preserve long-term associations between the various partners involved. In any community it is elementary to establish self-imposed codes of behaviour and to monitor their adherence so that all may have the hope of prospering.

7. Conclusions

To those who may feel that my picture of reinsurance today is painted in too sombre tones, I would say "Take heart we have seen it all before," even if from another angle and with a different perspective. The history of the reinsurance business is studded with daunting and recurrent crises and at no set pinpoint of time could the future prospects of the business ever be regarded with confidence without the addition of a strong dose of optimism to relieve the awesome problems that seemed so often to envelop reinsurers aspirations. Quite possibly it is just this habitually unpromising outlook that has enabled reinsurers to secure the terms of trade on which the business, for those who have survived, has prospered to an eminently acceptable level. This is of course to some extent what has attracted the massive inflow of newcomers to set the roundabout going again once more. But this is no simple merry-go-round. The factors that create competition and excessive capacity in the market place are as subtle and various as those that in turn bring about its withdrawal. No single cause or stimulus is ever entirely obvious or even predictable except by guess work. In fact like any true market the reinsurance market is volatile and temperamental and subject to continuous and kaleidoscopic change. Very few forecasts are validated by events which have an uncanny knack of arriving unheralded over a clear horizon. The industry has never been short of would be soothsayers, but none have achieved much of a following. Against this background my confident prediction is that, in spite of all, established practitioners of reinsurance will continue to prosper, providing always that they stick to the rules of the game. The characteristics of the business special to it, such as its long term nature, its internationality and multi-currency transactions, its dependence on personal trust and goodwill call for special treatment. Reinsurance is not the same as insurance, it is different, for example, both in its timescale and its dimension and to be successful must accordingly be handled differently.