

Where are the black holes?

By Ian Marshall

Does a reinsurer always know where its exposures lie? This can be a difficult question to answer if, for example, management or underwriters have changed, or if management is geographically remote from the operation.

What sets the non-life reinsurance industry apart is the complexity and variability of the business combined with less than historically rigorous documentation practices. The business complexity and risk has, of course, been heightened particularly in liability business by changes in the legal environment and a greater propensity to seek damages from insured parties.

By reference to actual situations, this article seeks to highlight the need for review of the past and present operation from a technical reinsurance perspective in order to diminish the likelihood of surprises in the future.

Clearly, all insurance and reinsurance business starts with underwriting and losses follow thereafter over potentially long periods. The application of actuarial techniques to estimate loss development is well known. The reliability of such techniques diminishes with the availability of information regarding the portfolio. A reinsurer who has not continued to monitor the exposure in all segments of the portfolio is less likely to be able to establish appropriate reserves than a reinsurer who has complete awareness of the business written.

This situation is far more likely to occur in the climate of recent years. When stability was more prevalent, knowledge of the business was more frequently retained within a company's management. On the other hand where, for example, companies underwrote through agents or on joint stamps, the principals may have never had detailed information regarding the risks underwritten. It becomes difficult for proper reserves to be established in such a situation.

None of this would be a problem were it not for long development tail associated with many types of reinsurance. Where management remote to the business has to make decisions regarding strategy, unless informed knowledge of the underwriting history is available, this task can be difficult.

This type of information is also essential in determining resources needed to manage a run-off, whether internally or through a management company. For example a company having decided to cease underwriting should analyse the inforce business. The length of period a company remains on risk after cessation of underwriting is often a surprise. Line slips, multi-year policies and extended discovery period on claims made policies all extend the period risk beyond what might otherwise be expected.

The black hole with the highest profile in London is the sufficiency and collectibility of reinsurance protections. The effect of either not being able to or failing to monitor accumulations of risk has had substantial publicity due to the insolvency of various LMX underwriting companies and the LMX Lloyd's Names Action Groups. Within the boundaries of catastrophe failures and best practice are various degrees of knowledge of and attitude to risk and reinsurance cost, all of which contribute to the ultimate net loss exposure.

The end of the reinsurance cycle is collection of recoveries from reinsurers. The London Market has been plagued with the effects of failing to control reinsurance debts, perhaps due to over reliance on brokers to maintain records by reinsurer. Unlike the other areas, this hole arises due to accounting systems deficiencies, rather than the difficulty in recording and returning intangible knowledge. Although computer packages are available to remedy the system deficiencies the time and cost needed to reconstruct the data can be substantial. The cost of failing to control reinsurance recoverables can, of course, be more substantial due to the potential bad debt expense.

The need to identify offsets relating to insolvencies and to commute with weak reinsurers and the greater degree of information required by industry regulators (such as Department of Trade and Industry or State Insurance Departments in the USA) should also add to the incentive to eliminate this particular black hole.

In the claims area, the black hole syndrome should in theory, be less in evidence. Businesses in all fields tend to control payments above all else. However, in reinsurance, various factors contribute to a lack of certainty even in this area.

Different attitudes towards claims reserving provide one example of why further analysis can be needed to obtain management information. Varying options regarding liability for pollution claims will be reflected in differing reserve levels. The exposure can be hidden if nominal precautionary reserves are established, since the amounts posted are below the threshold for executive or head office review.

One unfortunate by-product of the bureaux processing systems, particularly for following market reinsurers in London is that the claims function can become too much a processing function. Knowledge within a company regarding the reasons for loss development trends is more difficult to obtain, since part of the claim control function has essentially been delegated.

The ultimate uncertainty in reserves is, of course, the estimation of IBNR reserves. No matter how basic or sophisticated the process, there is inevitably a range of possible outcomes and the range may be substantial. The estimate that a company's management selects within the range each period contributes to the unrecognised exposure. It is self evident that a company always at the low end of the range of ultimate outcomes is more likely to be exposed to future deterioration.

How can these potential holes be filled? Retention of the knowledge of senior management, for instance, following cessation of underwriting or change of ownership can solve part of the problem, particularly on the underwriting side. This can be accomplished by consultancy agreements or retainers, if the personnel involved are not taking employment elsewhere.

In other areas there is no substitute for periodic reviews. At least part of this could come through the internal audit function, particularly in larger companies. However, where specialised reinsurance knowledge is required, outsourcing to specialists could be needed, unless personnel with the relevant skills can be seconded from other parts of the organisation.

If the holes cannot be filled internally, external specialists can provide the factual information which parent company management or head office needs to make informed strategic decisions.

There can be no doubt that head office management, even in cases where the parent company is in a different business now has more realistic expectations about the time needed to identify and solve a reinsurance company's weaknesses compared to the 1980's. Nevertheless, a periodic analysis of the exposure areas provides management with the information to be proactive rather than reactive to both historical problems and current weaknesses.

The differentiation between historical and current weak points can be illustrated by reference to one element of the reinsurance cycle, reinsurance protection. The historic weakness come about by failing to identify potential irrecoverable reinsurance before it is too late to minimise the loss. In the same area, a current weakness would be the failure to implement a reinsurance security acceptance procedure to minimise the risk that the current reinsurers are tomorrow's liquidations.

Although the problems of the reinsurance industry have not diminished, in general terms solutions are more readily available. For example in the systems area, far more cost effective and efficient systems are available and doubtless further advances will continue to be made at a rapid pace. There is also greater availability of specialist services, both for outsourcing and consulting, to help identify the black holes and solutions.

None of these points should trouble companies which are examples of best practice, but unfortunately the industry has historically been characterised by divergent standards. This divergence has given rise to the thoughts expressed in this article.